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DRAFT

ASSESSORS' HANDBOOK
SECTION 571

ADVANCED APPRAISAL: ASSESSMENT OF
PERSONAL PROPERTY AND FIXTURES

MARCH 1998

CALIFORNIA STATE BOARD OF EQUALIZATION

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DRAFT**CHAPTER 1: INTRODUCTION****WHAT IS TAXABLE**

Article XIII, section 1 of the California Constitution defines taxable property:

Unless otherwise provided by this Constitution or the laws of the United States.

(a) All property is taxable and shall be assessed at the same percentage of fair market value. When a value standard other than fair market value is prescribed by this Constitution or by statute authorized by this Constitution, the same percentage shall be applied to determine the assessed value. The value to which the percentage is applied, whether it be the fair market value or not, shall be known for property tax purposes as the full value.

(b) All property so assessed shall be taxed in proportion to its full value.

All property is taxable unless it is exempt by the Constitution or statutes.¹ This taxable property may be defined as real property and personal property. This section of the *Assessors' Handbook* deals with appraisal and assessment procedures for taxable personal property and fixtures, and it includes discussions of property tax audits, roll changes, and reporting requirements.

WHAT IS TAXABLE PERSONAL PROPERTY

Real property is specifically defined by the law. Real property, or real estate, is:

(a) The possession of, claim to, ownership of, or right to the possession of land.

(b) All mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto.

(c) Improvements.²

¹ The county assessor is responsible for the assessment of most property. However, the California Constitution (article XIII, section 19) requires the Board of Equalization to assess property (except franchises) owned or used by regulated railway, telegraph or telephone companies, car companies operating on railways in the state, and companies transmitting or selling gas or electricity. It also requires the Board to assess pipelines, flumes, canals, ditches, and aqueducts lying within two or more counties. The assessed values as determined by the Board (except for the railway car companies) are allocated to the counties and other local tax jurisdictions.

² Revenue and Taxation Code section 104. (All section references in this section of the handbook refer to Revenue and Taxation Code sections unless otherwise noted.)

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Personal property, on the other hand, is defined by exception; personal property is all property except real estate.³ It is all "property that may be seen, weighed, measured, felt, or touched, or which is in any manner perceptible to the senses" except real property as defined above.⁴

All property defined as personal property is not necessarily taxable. Unlike real property, personal property may, in whole or in part, be exempt by the Legislature. Examples of current exemptions provided by legislative statute include: business inventories, household furnishings, and pets. But, in general, personal property remains taxable.

Assessment of taxable personal property relies on the same basic value concepts applicable to real property, and both are taxed at the same maximum percentage (1 percent) of full cash value (or market value).⁵ However, personal property is treated differently in many other respects. Some of the most notable differences, also identified in *Assessors' Handbook Section 501* (AH 501), *Basic Appraisal*,⁶ are:

- Special assessments are levied on real property only.
- The Legislature has wide authority pursuant to article XIII, section 2, of the Constitution concerning the taxation and/or exemption of personal property.
- Personal property cannot be assessed to insurance companies or banks.⁷
- Real property is governed by article XIII A, while personal property is appraised at market value annually.⁸
- There is no taxable possessory interest in personal property, except as provided for in section 201.5.
- Before declines in value can be recognized, machinery and equipment classified as improvements must be separated from other improvements.⁹

An appraiser or auditor appraiser assessing personal property should be familiar with these differences, as well as other basic appraisal concepts as discussed in AH 501, *Basic Appraisal*, and generally accepted accounting principles (GAAP). This handbook section builds on that basic understanding with a focus on guidelines for the appraisal and assessment of personal property and fixtures, as it differs from real property.

³ Section 106.

⁴ Rule 123 of Title 18 of the California Code of Regulations. (All rule references in this section of the handbook refer to the Property Tax Rules in Title 18 of the California Code of Regulations.)

⁵ California Constitution, article XIII, section 1 and article XIII A, section 1.

⁶ All references to *Assessors' Handbook* sections refer to handbooks published and produced by the California State Board of Equalization. Publication dates will vary and will be noted, with page numbers, if specific to the discussion.

⁷ California Constitution, article XIII, sections 27 and 28 and Revenue and Taxation Code section 23182.

⁸ Manufactured homes and floating homes, although classified as personal property, are assessed in the same manner as real property. See Revenue and Taxation Code section 229 and sections 5802 et seq.

⁹ Rule 461(d).

DRAFT**GENERAL OVERVIEW OF THE SEVEN FACTORS OF AN ASSESSMENT**

The making of an assessment requires the determination of seven factors for that assessment to be proper and complete. These seven factors are especially important regarding personal property because they can be more difficult to determine and they often tend to change. The seven factors are *Taxability, Assessee, Situs, Description, Classification, Security, and Value*.

A brief description of each of the factors is included here as a foundation for additional information presented in the text. A more thorough study of *Situs, Classification, and Value* is necessary to make an accurate assessment of personal property; these three factors are each discussed in detail in separate chapters of this manual.

TAXABILITY OF THE PROPERTY**Taxable Property v. Exempt Property**

In the making of an assessment, the first determination is whether the property is taxable or exempt. If property is not taxable, the remaining factors become moot.

As previously noted, article XIII, section 1 of the California Constitution states that, unless otherwise exempt as provided by the State Constitution or the laws of the United States, all property is taxable. While real property may be exempt specifically by the State or U.S. Constitution only, the Legislature has been granted general power to exempt personal property in whole or in part. Article XIII, section 2 of the California Constitution states, in part:

The Legislature may provide for property taxation of all forms of tangible personal property, shares of capital stock, evidences of indebtedness, and any legal or equitable interest therein not exempt under any other provision of this article. The Legislature, two-thirds of the membership of each house concurring, may classify such personal property for differential taxation or for exemption.

Personal property is and can be exempt by the Legislature by reason of its *ownership, use, and type*. For example, personal property owned by banks, financial corporations, and insurance companies is exempt by *ownership*¹⁰ while property used by free public libraries is exempt by *use*.¹¹ Business inventories and household personal property are exempt by *type*.¹² Property may be exempt by one or more of these reasons. For instance, in 1994 a new statute was added to exempt the first \$20,000 of employee-owned hand tools.¹³ This is an exemption by *ownership* and *use*.

¹⁰ California Constitution, article XIII, section 28 prohibits taxation of personal property to insurance companies. California Constitution, article XIII, section 27 and Revenue and Taxation Code section 23182 provides for exemption of personal property owned by banks and financial corporations; this exemption does not apply to personal property owned by federal credit unions.

¹¹ California Constitution, article XIII, section 3.

¹² Section 219 and section 224, respectively.

¹³ Section 241.

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Certain exemptions exist under the State or U.S. Constitution, apart from Legislative enactment, because of *lack of tax assessment jurisdiction*. For example, personal property on certain military reservations (federal enclaves) and Indian reservations is immune from taxation due to *lack of jurisdiction*.

Article XIII, section 3 and the 200 and 900 series of the Revenue and Taxation Code sections identify real and personal property exemptions as granted by the Constitution and the Legislature respectively. It is important for an appraiser to be aware of exemptions in general in order to determine taxability of the property being appraised. It is also important to note that not all exemptions are automatic. Some are allowed only if appropriate forms are filed timely.¹⁴ In these cases, the property remains taxable unless an exemption claim is filed and approved.

Statute of Limitations

Sections 51.5 and 532 establish *Statutes of Limitations* on the assessor, which affect the taxability of property. Although a property itself is not exempt, an assessment must be made timely to be valid. Unless the taxpayer intentionally evades taxation, as discussed in sections 502, 503, and subdivision (c) of 51.5, an assessment must normally be made within four years of the assessment period in which the property escaped taxation or was underassessed. (This topic is discussed further in Chapter 9, *Roll Procedures*.)

Lien Date

Sections 2192 and 722 identify the lien date as January 1.¹⁵ Personal property is assessable only if taxable on this date.

Following is an example of how the lien date affects the assessment as determined by the assessor:

¹⁴ See *Assessors' Handbook* Section 222 (AH 222), *Standard Form List* (Revised Yearly); Section 267 (AH 267), *Church and Welfare Exemptions*; and Section 265 (AH 265), *Cemetery Exemption*, for information regarding exemptions and requirements necessary to qualify and receive an exemption.

¹⁵ Effective January 1, 1997, the lien date for locally assessed property was changed from 12:01 A.M. March 1, to 12:01 A.M. January 1.

DRAFT**Example 1.1: Lien Date**

On the lien date, January 1, 1997, a boat owned by owner A located in Sacramento. The taxpayer (owner A) sells the vessel to a boat dealer (owner B) on January 15, 1997. It becomes inventory to owner B on that date.

Owner A receives a tax bill for the fiscal year July 1, 1997, through June 30, 1998, for the assessment of the vessel. The assessee does not own the boat during the fiscal year the bill covers, but the bill is valid based on ownership on the lien date (owner A was the owner on the lien date, January 1, 1997).

If the sale were reversed, and the dealer sold the boat to owner A after the lien date, the boat would be exempt as inventory even though owner A owned the boat from January 15 through June 30, 1997. Ownership on the lien date generally determines the taxability, situs, and proper assessee of the property.

ASSESSEE OF THE PROPERTY

In determining the proper assessee, the assessor is not limited to only the fee owners of the property. Sections 405 and 611 authorize the assessor to tax the owners, persons in possession or control, joint assesseees, and/or unknown owners of any property.

Owner, One Who is in Possession or Control

Section 405 identifies the assessee as the "person owning, claiming, possessing, or controlling it on the lien date." Under most circumstances, this will be the owner. However, the assessee may be one who is simply in possession or control although not the legal owner. This is often the case with leased equipment and improvements related to business property.

It is also important that the assessee's name is accurately spelled or abbreviated. A person must be able to reasonably ascertain that he or she is the assessee. "A mistake in the name of an owner or supposed owner of property on the unsecured roll which does not prevent the person from reasonably ascertaining that he or she is the assessee does not render invalid an assessment or any tax sale."¹⁶

Assessee of Leased Equipment

With regard to leased equipment, either the lessor or the lessee may be the proper assessee. Typically,

- if the lease is a true lease, the lessor is considered the owner and therefore the assessee;
- if the lease is a finance lease or conditional sales contract, the lessee is technically the owner, and thus is the proper assessee.

¹⁶ Section 613.

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However, in practice, leasing transactions can be complicated and the determination of the proper assessee may not be straight forward. For example, if the lessor is unknown (in either case listed above) the lessee may be assessed. If the lessor is a bank or financial institution (financial corporation) which is exempt from personal property taxes, section 235 provides that the *lessee* is the *owner* (and therefore the proper assessee) for property tax purposes. Communication with the two parties to the lease and/or review of the lease or financing agreement helps to alleviate problems. (See also discussion of leased equipment in Chapter 4 and Chapter 6).

Assessee of Leasehold Improvements

Tenant improvements can also cause similar problems in identifying the proper assessee. Improvements installed by tenants may be assessed to either the landlord (the lessor) or the tenant (the lessee). General practice is to include improvements that are considered an integral part of the landlord's structure as real property. Thus, they are assessed to the landlord on the secured roll. Fixtures owned by the tenant, which are improvements by definition (section 105), and tenant-owned fixed machinery and equipment are assessed to the tenant. However, as with leased equipment, the proper assessee must be determined according to facts specific to each case.

Again communication with the two (probable) assessees is helpful, but the appraiser's and auditor appraiser's cooperation also assists in resolving problems for clarifying factual questions. As will be discussed later in the manual, Chapter 2, *Classification*, and Chapter 5, *Assessment of Improvements Related to Business Property*, the two appraiser should review the lease agreement and coordinate their fact-gathering efforts where ambiguity exists.

Joint Assesseees

In every situation an effort should be made to determine the proper assessee. It is preferable to assess only one party (the proper assessee) to avoid administrative difficulties, but the assessor has the authority to assess personal property to the lessor, the lessee, or both parties.¹⁷

When both parties are assessed, tax bills are required to be sent to both parties. This requirement presents a difficulty in that dual tax bills may result in dual payments. The assessor cannot indicate primary and secondary liabilities; the property tax statutes do not recognize such differences. Should both persons pay the tax, the tax collector must accept the first payment and refund the second. Therefore, the assessor should confine the joint assessment procedure to those cases in which a collection problem is anticipated.

Unknown Owner

In contrast to section 405, section 611 requires the assessor to assess property to unknown owners if the owner of the property is not known. If the property is assessed to unknown owners, the property may be seized and sold in order to pay property taxes.¹⁸

¹⁷ Section 405(b).

¹⁸ *Weyse v. Crawford* (1890) 85 Cal. 196.

DRAFT**1 SITUS OF THE PROPERTY**

2 Pursuant to California Constitution, article XIII, section 14, all property taxed by local
3 government shall be assessed in the county, city, and district in which it is situated. Thus, situs
4 determination is important.

5 Situs is seldom a problem with property that remains in one location, as in the case of real
6 property, but many problems are encountered when determining the situs of movable property
7 such as personal property. Rules 201 through 205 were adopted to deal with situs problems
8 involving movable property. A complete discussion of these rules and situs in general is included
9 in Chapter 3 of this manual.

10 DESCRIPTION OF THE PROPERTY

11 An accurate assessment requires a description of the property assessed. Personal property, as
12 required by section 445, must be described in the detail requested on the property statement. The
13 description includes the cost of the property, if the information is within the knowledge of the
14 assessee or is available to him/her from his/her own or other records.¹⁹

15 The property statement, mandated by section 441, is a vital link in the communication system
16 between the property owner and the assessor. It requests a variety of information regarding
17 taxable property needed by the appraiser and auditor appraiser for making an annual review and
18 accurate assessment of the property. A detailed discussion of property statements, the nature of
19 the reporting process, and variations of property statements related to different types of property
20 is found in Chapter 7 of this manual.

21 CLASSIFICATION OF THE PROPERTY

22 In accordance with the California Constitution and related statutes, all property on the roll must be
23 classified as real estate except improvements (land), improvements, or personal property.²⁰ Rules
24 121 through 124 identify the proper classification. Classification is one of the more complex and
25 important of the seven factors of a legal assessment. It is covered in detail in a separate chapter
26 (Chapter 2) of this manual.

27 SECURITY OF THE PROPERTY

28 An *assessment roll*, as defined in section 109, is the entire listing of all taxable property within the
29 county.²¹ (The assessor actually prepares two separate rolls each year: the *regular assessment*
30 *roll* and the *supplemental assessment roll*.) The assessment roll consists of two parts -- secured
31 and unsecured.

¹⁹ Section 445.

²⁰ Section 602 and 607, and California Constitution, article XIII, section 13.

²¹ The entire assessment roll includes the "local roll" which is the county assessor's duty to assess, and the "board roll", which is part of the secured roll, containing State assessed property.

DRAFT**Secured Property Defined:**

The "secured roll" is that part of the roll containing state assessed property and property the taxes on which are a lien on real property sufficient, in the opinion of the assessor, to secure payment of the taxes.²² The taxes are a lien on the property

Unsecured Property Defined:

The remainder of the roll is the "unsecured roll."²³ The taxes are a personal liability of the owner.

Assessments on the two parts of the roll have different due dates, delinquency dates, and tax collection procedures. In addition, on any given year, the tax rates between the secured and unsecured rolls may be different; the tax rate on the secured roll is the rate of the prior year's secured roll.²⁴ Therefore, it is necessary to determine whether each assessment will be listed on the secured or the unsecured roll.

Securing Personal Property

Most personal property has a degree of mobility; it can be moved from location to location or out of the taxing jurisdiction in which it had situs on the lien date. This can create difficulties in tax collection. It is therefore desirable to secure personal property to real property, which has a fixed situs, to facilitate payment of the taxes.

In determining whether personal property may be placed on the secured roll, the assessor is guided by sections 2189 et seq. and by *Assessors' Handbook* Section 201 (AH 201), *Assessment Roll Procedures*. Under section 2189, personal property may be placed on the secured roll when the property is physically located on the real property and is assessed to the person who owned the real property on the lien date. Upon taxpayer request, personal property at a different location may also be secured to real property under section 2189.3; this is known as cross securing. When personal property is cross secured, the assessor will determine whether or not the real property is sufficient to secure the payment of the taxes. If so, a *Certificate of Security* for taxes on personal property will be issued which must be recorded with the county recorder on or before the lien date.

When personal property is secured to real property and the real property (but not the personal property) is sold after the lien date but before the assessment is made, administrative difficulties may occur. The new owner of the realty may be assessed for personalty that he never owned or possessed. In this case, even though the initial assessment was valid due to the conditions on the lien date, the assessor is required to transfer the personal property assessment to the unsecured roll.²⁵ The escrow company would take care of this situation if the sale occurred after the assessment date due to availability of the information.

²² Section 109.

²³ Section 109.

²⁴ California Constitution, article XIII, section 12.

²⁵ Section 2189.

DRAFT**1 VALUE OF THE PROPERTY**

2 Value, for property tax purposes, is *market value*. This is the price (the amount of money) that a
 3 property will bring when it is sold in a market. It is a dollar amount determined by the utility of
 4 the property, as manifested through the purchasing power of those who are interested in acquiring
 5 it; the relative scarcity of the commodity; and the difficulty involved in overcoming this scarcity.
 6 In other words, value (market value) is determined by supply and demand.²⁶

7 The California Supreme Court, in a benchmark decision, defined the term *market value* as used in
 8 the context of property tax assessment.

9 It provides, in other words, for an assessment at the price that property would
 10 bring to its owner if it were offered for sale on an open market under conditions
 11 which neither the buyer nor the seller could take advantage of the exigencies of the
 12 other. It is a measure of desirability translated into money amounts...and might be
 13 called the market value of property for use in its present condition.²⁷

14 Similarly, the Legislature has defined the term in sections 110 and 110.1. Section 110(a) states:

15 Except as is otherwise provided in Section 110.1, "full cash value" or "fair market
 16 value" means the amount of cash or its equivalent that property would bring if
 17 exposed for sale in the open market under conditions in which neither buyer nor
 18 seller could take advantage of the exigencies of the other and both with knowledge
 19 of all the uses and purposes to which the property is adapted and for which it is
 20 capable of being used and of the enforceable restrictions upon those uses and
 21 purposes.

22 Of the seven factors in an assessment, value is consistently the most difficult. AH 501, *Basic*
 23 *Appraisal*, includes a comprehensive study of the value concept in general and an in-depth
 24 discussion of value as applied to real property.²⁸ In many respects, the same basic principles
 25 discussed in that section apply to personal property. However, unlike most real property,
 26 personal property is assessed at market value every year; it is not governed by the value
 27 limitations under Proposition 13 (California Constitution, article XIII A). Except for
 28 manufactured homes and floating homes, there is no base year value for personal property and the
 29 appraisal date is always the lien date, January 1. Further discussion of value, specific to personal
 30 property and fixtures, is a major portion of this section of the *Assessors' Handbook*. It is included
 31 in Chapter 4, *Valuation of Personal Property*; Chapter 5, *Assessment of Improvements Related to*
 32 *Business Property*; and Chapter 6, *Special Issues*.

²⁶ Supply and demand are the market effects of scarcity and utility.

²⁷ *De Luz Homes Inc. v. County of San Diego* (1955) 45 Cal.2d 546.

²⁸ Valuation of personal property also discussed briefly in AH 501, Chapter 7.

DRAFT**CHAPTER 2: CLASSIFICATION****IMPORTANCE OF CLASSIFICATION**

Classification is an important and required factor of the (local) assessment function for several reasons.²⁹ Principally, it is important because property tax law requires that land, improvements (including fixtures), and/or personal property must have separately assessed values shown on the roll.³⁰ It is also significant because of the valuation differences between real property and personal property, which include the following: (1) special assessments are levied only on real property, (2) tax rate on the unsecured roll is the rate of the prior years secured roll,³¹ (3) personal property is appraised annually at market value and not governed by article XIII A of the California Constitution, and (4) fixtures are a separate appraisal unit when appraising and recognizing declines in value and new construction.

GENERAL CLASSIFICATION TYPES AS REQUIRED BY LAW

Section 602 provides, in part, that the local roll shall show:

(e) The assessed value of real estate, except improvements.

(f) The assessed value of improvements on the real estate.

(g) The assessed value of improvements assessed to any person other than the owner of the land.

(i) The assessed value of personal property, other than intangibles.

This means that all property listed on the roll must be classified as (1) land, which is all real property except improvements, (2) improvements, or (3) personal property.

Each classification is defined in the Revenue and Taxation code (sections 104, 105, and 106) and by Title 18 of the California Code of Regulations (Rules 121, 122, 122.5, and 123). The definitions are summarized here for ease of use and reference. Examples are included as necessary for clarification.

²⁹ Classification does not apply to state assessed properties. "The Board may use the principle of unit valuation in valuing properties of an assessee that are operated as a unit in a primary function of the assessee. In valuing such properties, the Board must appraise them at their full values when put their beneficial and productive uses. Unit taxation prevents real but intangible value from escaping assessment and taxation by treating public utility property as a whole, undifferentiated into separate assets such as land or buildings, or even separate kinds of assets such as realty or personalty." *GTE Sprint Communications Corp. v. Alameda County* (1994) 26 Cal.App.4th 992.

³⁰ Rule 252, and sections 602 and 607.

³¹ California State Constitution, article XIII, section 12.

DRAFT**LAND**

Land is identified by section 602(e) as real estate, or real property, except improvements. It includes:

- (a) The possession of, claim to, ownership of, or right to the possession of land.
- (b) All mines, minerals, and quarries in the land, all standing timber whether or not belonging to the owner of the land, and all rights and privileges appertaining thereto.³²

IMPROVEMENTS

Section 105 defines improvements as:

- (a) All buildings, structures, fixtures, and fences erected on or affixed to the land.
- (b) All fruit, nut bearing, or ornamental trees and vines, not of natural growth, and not exempt from taxation, except date palms under eight years of age.

Examples of property generally classified as improvements are listed in Rule 124(b). The listing is a guide to classification of those named and similar items.

For valuation purposes, all improvements can and must be subcategorized as structures and fixtures. This separation and distinction is extremely important and encompasses a large portion of the discussion in the remainder of the chapter.

PERSONAL PROPERTY

Personal property includes all property except real estate.³³ It is property that may be exempted, in whole or in part, by the Legislature. A discussion of personal property categories (taxable and exempt) is included in a later portion of this chapter.

CLASSIFICATION FOR VALUATION PURPOSES

As required by law for enrollment purposes, property must be classified as land, improvements, or personal property pursuant to the definitions provided in the previous section. For valuation purposes, however, property is categorized as land, structure items (improvements), fixtures (improvements), and personal property.

IMPROVEMENTS (STRUCTURE V. FIXTURE)

Both structure items and fixtures are improvements; they are not taxed separately. However, they are treated differently and separately for valuation purposes. It is therefore important to discuss and understand the terms in order to classify the improvements properly.

³² Section 104(a) and (b). See also Rule 121.

³³ Section 106.

DRAFT**Structure Items**

A *structure* improvement is "an edifice or building; an improvement."³⁴ It is an item commonly referred to as an improvement. The Business Property Statement defines *structure* as an improvement whose:

...primary use or purpose is for housing or accommodation of personnel, personalty, or fixtures and has no direct application to the process or function of the industry, trade, or profession.

Fixtures

In contrast to *structure*, *fixture* is a somewhat vague term in that it has different meanings to different people. For example, certain items (such as bathroom 'fixtures') may be denoted as "fixtures" by a business owner or an accountant, even though the property tax appraiser classifies them as structure improvements (rather than fixture improvements) for property tax purposes.³⁵

For property tax purposes, pursuant to Rule 122.5, a *fixture*³⁶ is:

... an item of tangible property, the nature of which was originally personalty, but which is classified as realty for property tax purposes because it is physically or constructively annexed to realty with the intent that it remain annexed indefinitely.

Three Tests for Determining Whether or Not an Article is a Fixture

In determining whether or not an article is a fixture, the application of the three tests set forth in Rule 122.5 must be applied to the evidence available. The three tests are:

- Physical Annexation (manner of annexation),
- Constructive Annexation (adaptability), and
- Intent.

Physical Annexation (Test)

The term "affixed to land" is the key to the physical annexation test. Section 660 of the Civil Code includes a definition of the term, which reads in part as follows:

A thing is deemed to be *affixed to land* when it is attached to it by roots, as in the case of trees, vines, or shrubs; or imbedded in it, as in the case of walls; or permanently resting upon it, as in the case of buildings; or permanently attached to what is thus permanent, as by means of cement, plaster nails, bolts, or screws. . .

³⁴ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "structure", p.353.

³⁵ In discussions with taxpayers and accountants, the auditor appraiser should keep in mind that the concept of fixtures for property tax purposes is not necessarily the same concept used by taxpayers. Where there is a contradiction between the taxpayer's or accountant's concept of classification and the express language of statutory and rule provisions, the statutes and rules are controlling for property tax purposes.

³⁶ For property tax purposes, fixtures include *trade fixtures* and *fixed equipment*. See also Chapter 5, *Assessment of Improvements Related to Business Property*.

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Thus, the test for physical annexation under Rule 122.5(b)(1) may be summarized as follows:

- If the property being classified cannot be removed without substantially damaging it or the real property with which it is being used, it is considered physically annexed. It is classified as a fixture.
- If the property can be removed without material damage but is actually attached, it is classified as a fixture, unless there is an intent manifested by outward appearance or historic usage, that the item is to be moved and used at other locations.

Simple wiring and conduit connections shall not be used as the sole reason to support physical annexation. However weight and/or size of the property, or construction or alteration of a structure built specifically to house the property may cause physical annexation.

Constructive Annexation (Test)

An item may be classified as a fixture even if it is not physically fastened to a building or other structure. This is the concept of constructive annexation, the second test. Constructive annexation per Rule 122.5(c)(1) may be summarized as follows: if the property is not physically annexed to realty, but is a necessary, integral, or working part of the realty, it is constructively annexed. Factors to be considered are: (1) is the nonattached item designed and/or committed for use with specific realty, and/or (2) whether the realty can perform its desired function without the nonattached item.

Constructive annexation, as well as physical annexation, is "installation specific". As such, visual inspection of the actual annexation or relationship of the item to the real property or improvements may be necessary. If the installation and/or removal aspects of the item remain unclear even after visual inspection, further information should be requested from the taxpayer. For instance, the taxpayer may be requested to provide the detailed procedures involved in the installation or removal of the item and an accounting of all costs before a final determination can be made.

Below is a list of items, which were formerly personal property, that are classified as improvements due to constructive annexation based on decisions of the court (and information specific to each case). The list should serve a guideline for determining if an item is classified as improvement using the test of constructive annexation.

DRAFT**Table 2A: Property Classified as Fixtures (Improvements) Due to Constructive Annexation**

- A ship anchored at a specially constructed pier with various land based support lines for water, sewage, air conditioning, heating, etc. *Specialty Restaurants, Corp. v. Los Angeles County* (1980) 111 Cal.App.3d 607 (Queen Mary case).
- Cranes mounted on specially installed rails at a wharf area. *Seatrains Terminals of California, Inc. v. County of Alameda* (1978) 83 Cal.App.3d 69.
- Movable structures anchored to realty by the force of gravity. *Rinaldi v. Goller* (1957) 48 Cal.2d 276.
- Portable buildings and movable machinery and equipment at shipyards. *Kaiser Co. v. Reid* (1947) 30 Cal.2d 610.
- Pumps of such a size they are not easily moved and from outward appearances, to third parties, appear to be permanent. *Bell v. Perris* (1942) 52 Cal.App.2d 66.
- Vault doors attached to vaults. (constituted a unit for use together) *San Diego Trust & Savings Bank v. San Diego County* (1940) 16 Cal.2d 142.
- Head sets and stools used with central office equipment. *Southern California Tel. Co. v. State Board of Equalization* (1938) 12 Cal.2d 127.

1

2 ***Intent (Test)***

3 Intent is the most important of the three tests and may be the deciding factor regarding
4 classification of property. Rule 122.5 (d)(1) states

5 Intent is the primary test of classification. Intent is measured with—not separately
6 from—the method of attachment or annexation. *If the appearance of the item*
7 *indicates that it is intended to remain annexed indefinitely, the item is a fixture*
8 *for property tax purposes.* Intent must be inferred from what is reasonably
9 manifested by outward appearance. An oral or written agreement between parties,
10 such as a contract between lessor and lessee, is not binding for purposes of
11 determining intent. [Italics added.]

12 Intent must be determined by physical facts, and is the means of applying the physical and
13 constructive annexation tests. For instance, great expense or difficulty in removal are indicative
14 of intended permanence.³⁷ Intent cannot be a hidden matter, but is "reasonably manifested by
15 outward appearances."³⁸ If an item appears physically attached to real property, an appraiser can

³⁷ *Morse Signal Devices v. Los Angeles* (1984) 161 Cal.App.3d 570, *Allstate Insurance Co. v. Los Angeles County* (1984) 161 Cal.App.3d 570, *Security Pacific National Bank v. Los Angeles County* (1984) 161 Cal.App.3d 877, *Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881.

³⁸ *Trabue Pittman Corp. v. County of Los Angeles* (1946), 29 Cal.2d 385, 397.

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1 assume that the intent of the annexation is that the item will remain attached unless there is other
2 evidence that indicates the attachment is only temporary.

3 The guiding precedent for determining intent is the California Supreme Court case, *Crocker*
4 *National Bank v. City & County of San Francisco* (1989) 49 Cal.3d 881. Here the Court found
5 that computer equipment is personalty even when a newly constructed building includes a data
6 processing center. The inclusion of safety, security, cooling, power, and fire suppression systems
7 designed into the building specifically for the computer center did not change the classification of
8 the equipment from personalty to a fixture. Excerpts from the decision provide instruction on the
9 importance of intent:

10 ...in determining whether an item constitutes a fixture, three criteria must be taken
11 into consideration: (1) the manner of its annexation to the realty; (2) its
12 adaptability to the use and purpose for which the realty is used; and (3) the
13 intention with which the annexation is made. It is also settled that for tax
14 purposes, the "intention" must be determined by the physical facts or reasonably
15 manifested outward appearances.

16 ...In resolving whether an item placed on the premises constitutes a fixture or
17 personal property, the aforelisted three elements do not play equal parts. In
18 making the determination in a particular case, the element of intent is regarded as a
19 crucial and overriding factor, with the other two criteria being considered only as
20 subsidiary ingredients relevant to the determination of intent. ... Because the legal
21 problem here is taxability, ... and because the "intent" here is constructive and not
22 actual, the test reduces itself to whether a reasonable person would consider the
23 intent to be a permanent part of the property, taking into account annexation,
24 adaptation, and other objective manifestations of permanence...

25 Finally, there are no other objective manifestations of permanence that are
26 sufficient to outweigh the manifestations revealed by the evidence bearing on
27 annexation and adaptation - viz., that the [computer] equipment did not constitute
28 a permanent part of the building. ...Accordingly, we conclude that a reasonable
29 person, taking into account annexation, adaptation, and other objective
30 manifestations of permanence, would not consider the equipment at issue to
31 constitute a permanent part of the building. [Emphasis added.]

Importance of Classification as Structure v. Fixture

32 As mentioned earlier, it is important to sub-classify improvements as structure items or fixtures
33 because they are treated differently for valuation and assessment purposes.³⁹ Structure items and
34 fixtures are treated differently in that:
35

³⁹ See Chapter 5, *Assessment of Improvements Related to Business Property*.

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- 1 • Fixtures are a separate "appraisal unit" when measuring value and declines in value (Rule
- 2 461(d)).
- 3 • Fixtures are a separate "appraisal unit" under "new construction".
- 4 • Fixtures are handled differently for supplemental roll purposes.
- 5 • The value of fixtures is a component in the determination of a mandatory audit.

6 Thus, care must be taken to properly classify improvements as structure items or fixtures. The
 7 danger with respect to improper classification of an item is that it could become subject to double
 8 assessment or may escape assessment. If an item such as a compressor, for example, is included
 9 in the real property appraisal of the building in which it is located (per Rule 124(b)), and the
 10 taxpayer lists the compressor on the Business Property Statement as a fixture used in the trade or
 11 industry, it may also be included in the appraisal of the business property, subjecting it to a double
 12 assessment. While this problem is addressed in detail in Chapter 5, but it bears repeating that
 13 much caution must be exercised in compiling and comparing appraisal data and making accurate
 14 classifications in order to avoid escapes and duplicate assessments.

Classification Guidelines

16 An appraiser should consider all three tests when classifying property; physical annexation,
 17 constructive annexation, and intent. Each test affects the final classification of the property
 18 based upon the evidence available. However, intent, as the courts have stated, is the most
 19 important and must be measured with--not separately from--the method of physical attachment or
 20 constructive annexation.

21 Although the three tests (physical annexation, constructive annexation, and intent) for
 22 determining whether or not an item is classified as a fixture has been provided by the code and by
 23 the court, lack of detailed statutory definitions has led to some confusion when attempting this
 24 (sub-) classification regarding improvements, structure versus fixture. Rule 463(c) defines a
 25 fixture in general ("an improvement whose use or purpose directly applies to or augments the
 26 process or function of a trade, industry, or profession"), but no specific examples are given in the
 27 statutes. *Assessors' Handbook* Section 581 (AH 581), *Equipment Index and Percent Good*
 28 *Factors*, provides some clarification by listing improvements by type, that is, when an
 29 improvement relates primarily to the structure (structure), and when an improvement relates
 30 mainly to the function of a trade, industry, or profession (fixture). This list is included in the
 31 appendix XX for review and ease of use. Each example in this list is classified only on
 32 the limited description offered. In practice, classification of a property should be based on all
 33 relevant facts concerning that property. For example, dual purpose improvements should be
 34 classified as to their primary purpose.

Special Classification Issues

36 Some types of property consistently create classification problems: automatic teller machines
 37 (ATMs), telephone systems, partitions, and service station fixtures. These categories of property
 38 and the classification issues involved with each are discussed below.

DRAFT**Classification of ATM's**

ATM's may be classified as personal property or fixtures. The determination which must be made on a case by case method. Most ATMs are owned by banks and financial institutions which by law are exempt from personal property tax (and are subject to an in-lieu franchise tax).⁴⁰ Therefore, classification of ATMs may determine taxability. Using the three tests of a fixture (physical annexation, constructive annexation, and intent) will aid an appraiser in the proper classification of ATMs.

Rule 122.5(e)(9) classifies ATMs that are installed as free standing or counter-top units within a building (such as a bank, supermarket, or other retail establishment), as personal property. An ATM installed in a structure that was built primarily for the purpose of housing the ATM is a fixture, because the realty cannot perform its main function without the ATM. Similarly, an ATM installed through the wall of a building is a fixture because that portion of the realty was designed or modified for the specific purpose of housing the ATM.

Classification of Telephone Systems

Telephone systems (not including state assessed telephone companies) often pose problems because there may be many different components making up the system as a whole, and each component must be analyzed and classified separately. The components integrated into the structure are physically annexed, generally having permanence (intended to be annexed indefinitely), and are therefore structure items. However, components that plug into the wiring system are not physically annexed to the structure. These components are necessary in order for the operation of the system (constructively annexed), but they are portable and can be used in other structures. Use of these components is not limited to only one system. The intent of the property owner is that these components be movable (i.e., when the realty is sold, the portable telephone components are not sold with it). This part of the telephone system is personal property.

Classification of Service Station Improvements

Service station improvements are also made up of many components. Each component should be identified, tested, and categorized individually consistent with existing statutory law, property tax rules, and standard appraisal principles. In general, fixtures include items such as signs, hoists, and tanks if they directly augment the function of the service station trade. Structure items include other improvements such as buildings, curbing, and landscaping; their primary use and purpose is for housing or accommodation of personnel, personalty, or fixtures. Items which have a dual purpose will be classified according to their primary purpose.

Following is a generalized listing of property typically found in connection with service stations and their appropriate categorization as proposed by industry:⁴¹ As technology advancements are

⁴⁰ Exempt banks and financial institutions do not include federally chartered credit unions. Personal property owned by federally chartered credit unions is not exempt from property taxes.

⁴¹ Categorization recommendation supplied by the Western States Petroleum Association Marketing Property Task Force.

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made and other changes occur in this industry, these general categorizations may need to be modified.

Table 2B: Classification of Service Station Improvements	
Structures	Fixtures
Buildings Curbing Paving Restrooms Walls Fencing Yard Lighting Landscaping Island Canopy	Island Curbing Signs Hoists Compressors Air & Water Wells Dispensers/Pumps Tanks & Related Equipment

Classification of Partitions

Partitions may be classified as either personal property, structure items, or fixtures. Each partition must be classified on the physical characteristics of the item.

Most partitions currently used in office buildings are not permanently attached or built into the structure. The partitions are designed to be rearranged easily to accommodate the current needs of the business. These types of partitions are properly classified as personal property.

Partitions built into the structure or designed to function only in a specific structure are improvements. They are physically annexed and can be classified as fixtures or structures as appropriate. Partitions that are floor-to-ceiling height, and for the most part constructed at the time the building is constructed, are structure improvements. Partitions in an office space that are less-than-ceiling height, attached to the floor, and constructed with studs and sheetrock or masonry materials are fixtures. In either case, the partitions will remain indefinitely.

PERSONAL PROPERTY (GENERAL CATEGORIES)

Personal property, as defined earlier is all property except real estate. Rule 123 defines (tangible) personal property as:

All property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses, except land and improvements, is tangible personal property.

In general, personal property is sub-classified according to type as provided on the property statement(s): equipment, supplies, vessels, aircraft, and manufactured homes. Each of these general categories is discussed below. However, not all personal property is assessable. It is, therefore, important to sub-classify this property further (e.g., business inventory, vehicles, etc.) In this case, classification affects not only valuation but may affect taxability.

DRAFT**Equipment**

The term *equipment* is a general term. The Business Property Statement subdivides equipment into the following categories: *machinery and equipment*; *office furniture and equipment*; *other equipment*; *tools, molds, dies, and jigs*; and *computer equipment*. *Machinery and equipment* includes equipment that is directly related to a particular industry (including equipment that is driven and controlled by a computer which is an integral part of the production equipment). For example, washers and dryers are types of equipment that laundromats would include in this category. The category titled *tools, molds, dies, and jigs* is limited to manufacturing industries; generally, it is self-explanatory to those industries. Other categories, *office equipment* and *computer equipment*, on the property statement represent equipment used by most types of businesses. Items such as desks, tables, chairs, and filing cabinets are included in *office equipment*. The column entitled *computer equipment* represents not only non-production computer components but also related equipment.⁴²

Supplies

Supplies are items that are used in the normal operation of the business and are not intended for sale or lease on the lien date. They are assessable as personal property at their current replacement cost, or market value. Assessable supplies do not, however, include any items that become an ingredient or component part of a product that is manufactured or sold in addition to items that are sold with the product. Examples of supply items which are exempt inventory when they are sold with the product include packaging boxes, pallets, price tags, and cash register tapes. These items are inventory and are exempt.⁴³ Examples of assessable supplies (items that do not become part of the product) include stationery and office supplies, chemicals, and precious metals used to produce a chemical or physical reaction, janitorial and lavatory supplies, fuel, and sandpaper. Medical,⁴⁴ legal, or accounting supplies held by a person in connection with a *profession* that is primarily a service activity may also be reportable as supplies. Items that are to be delivered to a customer as part of a *nonprofessional* service, such as chemicals added to a customer's pool by a swimming pool maintenance company, are inventory.

Business Inventory Exemption

It is important to distinguish supplies, which are assessable, from inventory items, which are exempt. Rule 133(a) identifies business inventory.⁴⁵ In short, business inventory includes all items of personalty that become part of or are themselves a product that is held for sale or lease in the ordinary course of business. The key phrases *ordinary course of business* and *goods intended for sale or lease* must apply for the property to qualify for the business inventory

⁴² Note: the Business Property Statement requests computer equipment (and related equipment) be reported separately based on cost of the computer system.

⁴³ Section 129 and 219, and Rule 133.

⁴⁴ Some medical supplies are considered inventory. Tangible property of a significant nature that becomes affixed to and/or permanently attached to a patient such as prosthesis, pacemakers, hip joints, pins, and artificial body parts and organs, for example, may be classified as inventory. Other examples of inventory include, but are not limited to, medicine, I.V. fluid, casts, splints, wraps, crutches and bone screws.

⁴⁵ Rule 133(b) describes property not eligible (exclusions) for the business inventory exemption.

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exemption. For example, a retailer in the business of selling shoes is also requesting a business inventory exemption on a vessel he/she is trying to sell on the lien date. Since the sales of vessels is not part of his/her *ordinary course of business*, the vessel would not qualify for the inventory exemption. If a copier leasing company holding machines for lease uses one of the machines prior to the lien date or intends to use the copier after the lien date, that copier is no longer part of the *goods intended for sale or lease* and would not qualify for the business inventory exemption even if it is held for lease on the lien date.

In general,

- Personal property (including animals, crops, and feed) sold in the ordinary course of business is exempt business inventory.
- Items incorporated into a product, sold in the ordinary course of business, is exempt business inventory.
- Goods transferred in the rendition of a professional service are *not* eligible for the business inventory exemption. (Examples are given later in this chapter.)
- Goods transferred in the rendition of a nonprofessional service are eligible for the business inventory exemption. (Examples are given later in this chapter.)
- Animals used in the production of food or fiber are exempt business inventories.
- Property held for lease on the lien date is exempt business inventory.

Tangible personal property that is owned or used rather than intended for sale or lease does not qualify for the business inventory exemption. Such equipment is taxable.

DRAFT**Questions & Answers Regarding Classification Of Supplies v. Inventory**

Following are some common questions and answers regarding the business inventory exemption. The questions are grouped into five categories: manufacturing, retailing, professional and service enterprises, agricultural enterprises, and property held for lease.

Manufacturing**Do manufacturing supplies qualify for the business inventory exemption?**

- Yes. Manufacturing supplies, that will be incorporated in a product that is to be sold; such as welding rods, nuts, bolts, and screws, are eligible.
- No. Supplies such as oxygen and acetylene for welding, drill bits, and similar items that are consumed in the manufacturing process but that are not physically incorporated into the product are not eligible. Also not eligible are catalysts used to accelerate chemical or physical reaction but which are not intentionally incorporated into the product.

Do dies, patterns, jigs, or tools held for use qualify for the business inventory exemption?

- No. Dies, patterns, jigs, and tools are taxable property when used in the ordinary course of business.

Are parts held by manufacturers to perform warranty service on products they sell eligible for the business inventory exemption?

- Yes. Although the parts are not sold outright, they are held for repair (replacement of defective parts) of products that are sold. The selling prices of the products will include amounts to cover normal warranty repairs.

Is sand and gravel held by a licensed contractor for incorporation into a bridge or road bed eligible for the business inventory exemption?

- Yes. Business inventories include all materials held by a licensed contractor which will be incorporated into real property, except those to be incorporated into real property which the contractor is constructing for his own use.

Is factory built housing held for sale by the manufacturer eligible for the business inventory exemption?

- Yes. If held for sale as individual sections of a building, they would be eligible. They would also be eligible where the manufacturer is also a licensed contractor and assembles the sections at a building site, then sells the buildings.

Retailing**Is farm or construction equipment, that was previously used by a farmer or contractor, eligible for the business inventory exemption once it is consigned to an auctioneer for sale?**

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- Yes, the equipment is held for sale by the auctioneer whose normal business is selling such goods.

Farm or construction equipment is held and advertised by a farmer or contractor for sale as a means of disposing of old or excess equipment. Is such equipment eligible for the business inventory exemption?

- No. It is not held for sale in the normal course of business. Their business is farming or contracting, not selling used equipment.

Are display items eligible for the business inventory exemption?

- Yes, unless they have been altered to the point where it is unlikely they will be sold. An example of a display that is not eligible is a cut-away of a tire showing the interior construction. Such an item would not be sold by the retailer; thus, it is not eligible for the exemption.

Are salesperson's samples eligible for the business inventory exemption?

- Yes, if items are sold from the samples or if the samples are periodically rotated and returned to stock for sale.

A retailer selling office machines and equipment periodically removes equipment from inventory for use as his office equipment. The equipment is used for a period of time then returned to inventory for sale. The retailer insists the equipment is still for sale even though it is in use and has been removed from display. Is the equipment being used as office equipment by the retailer eligible for the business inventory exemption ?

- No. The equipment is in use at the consumer level and is not being displayed or otherwise offered for sale. If on the following lien date the equipment is back in stock (not in use), it is eligible for the inventory exemption if held for sale but is not eligible if held for lease.

Professional and Service Enterprises

Goods transferred in the rendition of a "professional service" are not eligible for the business inventory exemption, while goods transferred in the rendition of a "nonprofessional service" are eligible. What criteria determines whether a service is professional or nonprofessional?

- Rule 133(c) gives examples of medicine, law, architecture, or accountancy as "professional services". It lists dry cleaners, beauty shop operators, and swimming pool service companies as examples of "nonprofessional services". There are, of course, many services in between that are more difficult to assign to one group or the other. Following are criteria that can be used to distinguish between a profession or "professional service" and a "non-professional" service or enterprise.

A "profession" is a vocation where the labor and skill is predominantly mental or intellectual, rather than physical or manual. A "profession" requires knowledge of an

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advanced type in a given field of science or learning gained by a prolonged course of specialized instruction and study.

Are embalming fluids of a mortuary eligible for the business inventory exemption as goods transferred in the rendition of a non-professional service?

- Yes. The skills required of an embalmer are of a manual or mechanical nature.

Are medicines that a doctor keeps on hand business inventories?

- No, because they are typically transferred to patients incidental to the rendition of the professional service.

Are medicines held by a hospital pharmacy eligible for the business inventory exemption?

- Yes, if the hospital pharmacy holds medicines dedicated for sale to the general public (out-patients and/or walk-in customers) that portion held for resale is eligible for the business inventory exemption.
- No, medicines held by the hospital pharmacy for issue to in-patients as part of a service are not eligible for the business inventory exemption.

Is the food held for serving to hospital patients as part of the daily hospital service eligible for the business inventory exemption?

- No. The meals are incidental to the rendition of the professional service. However, food held for sale in the hospital cafeteria is eligible.

An accountant maintains a stock of accounting books which he passes on to his clients as a part of his service. He has a retailer's permit. Do the books qualify as business inventories?

- No. However, if the accountant regularly bills clients for the books as a separate item in addition to his services, the books would qualify for the exemption.

Are clothes hangers and plastic bags held by dry cleaners subject to the business inventory exemption?

- Yes, because they are delivered to customers regularly as part of the non-professional service performed.

Are chlorine tablets held in storage by a swimming pool service company business inventories?

- Yes, because they are delivered to customers as an item regularly included in the non-professional service.

Agricultural Enterprises

Are insecticides, fuel, and fertilizer held by a farmer subject to the business inventory exemption?

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- No, because these items are held for use rather than for sale.

Is feed that is held by a farmer for feeding to animals used in the production of food or fiber eligible for the business inventory exemption?

- Yes.

Are farm animals held for breeding purposes subject to the business inventory exemption?

- Yes, if their offspring are normally used as food for human consumption or for the production of fiber useful to man.

Are stallions and mares held for the production of offspring eligible for the business inventory exemption as "animals held for the breeding of livestock?"

- No. Those qualifying for exemption as "animals held for the breeding of livestock" are animals that produce offspring that will be used for food or fiber for human use or consumption.

Property held for lease

Are pack animals used by a guide to pack campers into the mountains eligible for the business inventory exemption?

- No. However, if the pack animals are held for lease to campers, are directly under the campers' control, and are not otherwise used by their owner, they would be eligible.

Are goods held for lease eligible for the business inventory exemption?

- Yes. "Held for lease" means that the property is not actually out on lease on the lien date and is not used by or intended to be used by the lessor for some purpose other than the prospective sale or lease of that property. Also, the property while on lease must be removed from the premises of the lessor and be placed under the control of the lessee.

Are vending machines held in the owner's hands that are normally placed on site to dispense food eligible for the business inventory exemption?

- No, unless the machines are held for rent. Placing them on site does not constitute a rental. Sharing of the receipts with the site owner constitutes payment for use of the site. (Note: The food in the vending machines is exempt.)

Are items eligible for the business inventory exemption if held for lease by a person who leased the items from someone else?

- Yes. The determining factor is the status of the items on the lien date; i.e., they are held for lease in the normal course of business.

Are boats held for rental purposes eligible for the business inventory exemption if, on the lien date, the rental operation is closed for the winter?

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- Yes. Even though the boats are not "held for rent" on the lien date due to the operation being closed for the winter, they are still eligible for the exemption since they are held for rent in the normal course of business.

Are golf carts held for short term rental eligible for the business inventory exemption?

- No. Assuming that the golf carts are only available for use on a golf course, the golf carts would not be eligible for the exemption. They are personal property, used in the ordinary course of business, assessable to the owner. To qualify as a lease, the property must be under the control of the lessee during the lease term.

Are the supplies of motor fuels held by a rental operation eligible for the business inventory exemption where the fuels will be provided to a customer with the rental of a machine?

- Yes. The fuel supplies are eligible whether billed separately or included in the rental charge.

Are linen supplies that are leased to customers eligible for the business inventory exemption?

No, not if on lease on the lien date.

Vehicles, Vessels, Aircraft, And Manufactured Homes

Vehicles, vessels, aircraft, and manufactured homes not on permanent foundations are also classified as personal property. They are taxable personal property to the owner, whether the owner is an individual, a business, or otherwise. To be taxable, there is no requirement that they be used for business purposes as other types of personal property.

Vehicles

Vehicles are broadly defined by both the statutes and case law. Section 670 of the Vehicle Code defines a vehicle as:

A "vehicle" is a device by which any person or property may be propelled, moved, or drawn upon a highway, excepting a device moved exclusively by human power or used exclusively upon stationary rails or tracks.

Court cases have further identified property classified as vehicles. In *Lambert v. Southern Counties Gas Co.* (1959) 52 Cal.2d 347, the California Supreme Court held that a bulldozer was a vehicle. The court stated:

For purposes of classification as "motor vehicle" under the broad definition of the Vehicle Code, it is not required that the device be one that may legally be "self propelled" upon a highway.

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In *Travelers Indem. Co. v. Colonial Ins. Co.* (1966) 242 Cal.App.2d 227, the court held that a forklift met the definition of a vehicle.

Transport argues that a forklift is neither designed nor used to haul persons or property on a public highway; that the forklift here involved was not so used; and that the Vehicle Code provisions exempting forklifts from registration show a legislative intention not to include them in the definition of "motor vehicle." We disagree.

Based on the Vehicle Code and the above court decisions, a device could be illegal to operate on the highway and exempt from vehicle registration but still be a *vehicle*. Accordingly, tractors, backhoes, bulldozers, forklifts, crawler loaders, golf carts, riding lawnmowers, unlicensed racecars, and any other type of equipment that is self propelled or is designed to be moved by something other than "exclusively human power" qualify as vehicles. These items therefore do not qualify for the exemption provided by section 224.

Motor vehicles (including trailers and recreational vehicles), that are "of a type subject to registration under the Vehicle Code," pay licensing fees to the Department of Motor Vehicles (DMV) "in-lieu" of property tax.⁴⁶ However, vehicles exempt from DMV registration requirements, per Vehicle Code Section 4000-4020, are taxable personal property.

Vehicles such as golf carts and riding lawn mowers are not exempt either as personal effects, nor as vehicles which pay in-lieu fees to the department of motor vehicles. Section 155.2 authorizes the county board of supervisors to provide for a low-value exemption of up to \$5,000. Such an exemption, if implemented in a county, will eliminate assessment of most household vehicles. However, no exemption would be available for vehicles such as tractors or backhoes that are worth more than \$5,000. They are nonexempt household personal property.

Vessels, Aircrafts, And Manufactured Homes

Assessment of vessels, aircraft, and manufactured homes are discussed in separate handbooks to give each subject the attention required. Vessels are discussed in *Assessors' Handbook* Section 576, *Vessel Assessment*. Aircraft are included in *Assessors' Handbook* Section 570 (AH 570), *Commercial Aircraft Value Allocation*, and Section 577 (AH 577), *General Aircraft Assessment Procedures*. Manufactured homes are covered in *Assessors' Handbook* Section 511 (AH 511), *Assessment of Manufactured Homes*.

⁴⁶ Section 10758.

DRAFT**CHAPTER 3: SITUS OF PERSONAL PROPERTY**

"All property taxed by the local government shall be assessed in the county, city, and district in which it is situated."⁴⁷ Situs, the place where property is legally situated, is therefore one of the essential factors of a valid assessment. For real property, situs usually needs to be determined only once. It will always be the same. Personal property, however, is mobile property with no fixed situs. Situs may always be the same or it may be different year to year, month to month, or day to day.

An appraiser for property tax purposes is only concerned with a property's taxable situs on the lien date—January 1—each year. On this date, property with a taxable situs located in California is taxable in California; property with a taxable situs outside of California is not taxable here. Similarly, property with a taxable situs in the jurisdiction of a taxing agency is taxable by that agency.

WHAT IS TAXABLE SITUS: PERMANENT V. TEMPORARY SITUS

Article XIII, section 14, provides that a property's taxable situs is the location where the property is "situated". "Situated" connotes a more or less permanent location, or situs. Thus, taxation of property in the state must be based on the fact that it is to some extent kept or maintained in California rather than here casually or in transit.⁴⁸ The statute does not refer to the temporary location of property, but to its permanent situs.⁴⁹

If property stays in one place, as does real property, this location is the permanent and taxable situs. However, even when property is moved periodically, a taxable situs is established at a given location on the lien date. For example, property which is normally located in a taxing jurisdiction, moved on the lien date, and then immediately moved back does not avoid taxation at this situs. Although gone on the lien date, the property has not established permanent situs elsewhere. Therefore, its permanent situs, and thus taxable situs, remains at the original location.

Since there is no requirement to keep one's property in a specific jurisdiction where it is subject to taxation, a taxpayer may move property only to avoid taxation. In doing so, the property must attain situs elsewhere. A degree of permanency must attach to that situs before that can happen.⁵⁰ Again, the word "situated" connotes a more or less permanent location or situs. Property may be removed to avoid the imposition of taxes if the removal is permanent. "If the removal is intended to be temporary, only for tax reduction purposes or otherwise, the property remains taxable at its permanent situs."⁵¹

⁴⁷ California Constitution, article XIII, section 14.

⁴⁸ *People v. Niles* (1868) 35 Cal. 282.

⁴⁹ *Rosasco v. County of Tuolumne* (1940) 143 Cal. 430.

⁵⁰ *Brock and Co. v. Board of Supervisors* (1937) 8 Cal.2d 286.

⁵¹ *Ibid.*

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On the other hand, property that is in California temporarily but which has a permanent taxable situs outside of California is not taxable in California. The California constitutional requirement (section 1, article XIII) that all property be taxed in proportion to its full value does not require or allow taxation of all property temporarily in this state. Property is taxable only in the county, city, and district in which it is situated or has situs.⁵² At all times there is property of great value that is being transported across this state, from one foreign state to another, that no one would claim should be taxed here.⁵³

In summary, permanent versus temporary situs must be considered when determining taxable situs for property tax purposes. This principle was upheld in the case of *Seegmiller v. County of Nevada* (1997) 53 Cal.App.4th 1397. A taxpayer moved his business property from a permanent location in California to a permanent location in the State of Nevada during August of the fiscal tax year. There was no dispute that the location of the equipment on the March 1 lien date⁵⁴ was Nevada County, California, but the taxpayer sued for a prorated assessment to avoid possible duplicate assessment of the property at the new location. The court found Nevada County's entire assessment valid based on permanent situs of the property (in that county) on the March 1 lien date. A permanent situs on the lien date is the basis for taxable situs.

DETERMINING SITUS OF MOVABLE PROPERTY

Property which is frequently moved, such as transportation equipment and construction equipment, is defined as *movable property* under Rule 205.

Movable property is all property which is intended to be, and is, moved from time to time from one location to another.

The situs of such property should be governed by the duration of its stay at any location as discussed generally in Rule 205, *Movable Property*, and referenced further in Rule 204, *Leased Equipment*, and Rule 203, *Property in Transit*.

GENERAL SITUS RULES (RULE 205)

Over Six Months Prior to the Lien Date

Movable property has situs where located on the lien date if (1) it has been in the county for more than 6 of the 12 months immediately preceding the lien date and (2) the objective facts indicate it will remain in or return to the county for any substantial period during the 12 months immediately succeeding the lien date. (Rule 205)

Less Than Six Months Prior to the Lien Date

Movable property which has been in the county for less than 6 of the 12 months immediately preceding the lien date, but which is committed to use in the county for an indeterminate period

⁵² California Constitution, article XIII, section 14.

⁵³ *City and County of San Francisco v. Talbot* (1883) 63 Cal. 485.

⁵⁴ Effective January 1, 1997, the lien date was changed from March 1 to January 1 pursuant to section 2192.

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or for more than 6 months, has situs there regardless of whether the use extends through or commences with the lien date. (Rule 205)

If the property does not meet the qualifications for situs as discussed above (over six months and less than six months), the situs of the property is the location where it returns between uses.

Movable Property In-Transit

Movable property may be in-transit on the lien date, and this may affect the property's taxable situs. As explained later in this chapter, situs and even taxability may be based on the destination of the property (whether in interstate, intrastate, or foreign commerce) and the terms of transit.

Situs Other Than at Location

Movable property that does not have permanent situs where it is located on the lien date has taxable situs at the location where it is normally returned between uses. If there is no such location, the situs is the principal place of business of the owner. (Rule 205)

Habitual Presence or Substantial Average Rule

In cases where property does not remain in one location long enough to establish a permanent location or situs, and does not have a location it normally returns to, its taxable situs is the place where it is frequently present or habitually located.⁵⁵ Instruments of commerce (commercial aircraft, railroad cars, barges, etc.), linen supplies, and returnable containers are common examples of property that attain a tax situs because there is a substantial average or habitual presence at a specific location.

Special rules have evolved for assessing and determining situs for most types of instruments of commerce. Where such statutes or rules do not exist, the courts have traditionally supported any reasonable method of apportionment. In *Sea-land Services, Inc. v. County of Alameda* (1974) 12 Cal.3d 772, the court found that an assessment of cargo containers based on an "average presence" was proper. In another case involving cargo containers, the United States Supreme Court also approved the concept of a property tax assessment based on average presence.⁵⁶ The assessment in this case was voided by the Court, however, because the cargo containers were foreign-owned instrumentalities of international commerce and a state may not tax such property.⁵⁷

Habitual Situs at More Than One Location in California

The habitual presence rule is applicable only to property which is (1) used in California *and* in other states or foreign nations and (2) not assessable under other regulatory formulas. Property that has taxable situs in California on the lien date is assessable at only one location, based on its value as of that date, even though the property may have substantial presence at more than one

⁵⁵ *GeoMetrics v. County of Santa Clara* (1982) 127 Cal.App.3d 940.

⁵⁶ *Japan Line, Ltd. v. County of Los Angeles* (1979) 441 U.S. 434.

⁵⁷ Note: all ocean-going cargo containers of 1,000 cubic feet or more are now exempt under section 232. This exemption does not affect the principle of tax situs due to habitual or average presence however.

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location.⁵⁸ Thus, if a property is in County "A" for seven months and County "B" for five months, County "A" will assess the entire property and County "B" may not assess the property at all. No apportionment of the assessment is required.

Habitual Situs Both in California and in Another State or Nation

The rules of situs are often affected by the requirements of apportionment where the property has a substantial presence in more than one state. Apportionment is a process used to allocate or eliminate, based on the time of presence, the assessments or the taxes for time spent out of the state. Apportionment is allowed under current law and is expressed in relatively recent court decisions which are discussed below. First, however, a brief discussion of federal law versus a state's power to tax is appropriate.

Federal Law versus State Law

Federal and state law must both be observed when determining situs and assessability of items which concern or have a taxable situs in states other than California because in several matters the federal government regulates interstate commerce. For example,

- the "commerce clause" (United States Constitution, article I, section 8, clause 3) *grants to Congress the power to regulate interstate and foreign commerce;*
- the "import-export clause" (United States Constitution, article I, section 10, clause 2) *prohibits states from levying taxes on imports or exports without the consent of Congress; and*
- the President of the United States (United States Constitution, article II, section 2, clause 2) *has the power, with the advice and consent of the Senate, to make treaties with foreign nations.*

While federal statutes do not limit ad valorem taxation by the states⁵⁹ and federal courts are prohibited from taking jurisdiction in tax assessment cases (unless it can be proved that a plain, speedy, and efficient remedy does not exist under state law),⁶⁰ related federal law does take precedence if a controversy arises.

It is clear that neither federal law nor the courts prohibit taxation of property that has presence in more than one state. However, apportionment may be required. Although there have been many state and federal court cases that deal with apportionment of taxes on instruments of interstate commerce,⁶¹ neither the courts nor the Congress has ever specified any particular method of

⁵⁸ An exception to this rule is certificated aircraft, scheduled air taxis, and inter-county ferryboats. See *Other Special Situs Situations*.

⁵⁹ With the exemption of railroads under the 4-R Act (section 306 of the Railroad Revitalization and Regulatory Reform Act of 1976) which prohibits discriminatory taxation against railroad cars traveling interstate.

⁶⁰ 28 U.S.C. section 1341

⁶¹ See *Assessor's Handbook* Section 570 (AH 570), *Commercial Aircraft Value Allocation*, for discussion of several cases involving allocation of instruments of interstate commerce.

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allocation or taxation. Several courts have commented that a slight overlapping of taxes (which occurs accidentally because different states have different rules of situs) is permissible. In general, the courts have only said that the state's tax system must provide for fair apportionment, not discriminate against interstate commerce, and be fairly related to the services provided by the state.

Apportionment Between States and/or Foreign Nations

As a result of *Ice Capades Inc. v. County of Los Angeles* (1976) 56 Cal.App.3d 745, it became necessary to apportion taxes on property that has established taxable situs (1) in California, and also (2) in another state. The court's ruling in this case (resulting in the *Ice Capades Rule*) made it clear that where multiple tax situs between states exists, tax must be apportioned. This apportionment should be based on the time of the property's presence, regardless of whether or not the other state(s) are actually taxing the property.

Ice Capades, Inc. v. County of Los Angeles involved a touring ice show which owned and operated facilities in both California and New Jersey. The Court held, among other things, that:

- apportionment applies only where property has a tax situs in more than one state;
- a taxpayer contending that some portion of property is not taxable by the state of domicile has the burden of proving by sufficient evidence that situs has been established elsewhere;
- in a borderline situation, it is reasonable to apportion the tax if the other jurisdiction actually levied a tax;
- transitory contact with other states does not establish taxable situs even though the visits were annual; and
- the transitory contact of certain types of property with various states is different than "habitual presence" of other types of property (instruments of commerce) typically present at a given location.

Thus, when property has situs in California but has its permanent or primary situs in another state or country, it is taxable here only to the extent of time spent here. Apportionment should be calculated based on the time that property had tax situs in California versus total time (e.g., 60 days in California divided by 365 days) when a sufficient quantum of contact has established situs here. A tax bill from another state may be relevant evidence in determining multiple tax situs, although the dollar amount of the other state's tax bill is irrelevant. When property is here on only a transitory basis this rule does not apply; the property is not taxable here.

Consistent with *Ice Capades*, if a California property has a substantial presence in another nation, the California assessment should be apportioned to eliminate that time the property has established situs outside the state, whether or not the foreign nation actually taxed the property.⁶²

⁶² *GeoMetrics v. County of Santa Clara* (1982) 127 Cal.App.3d 940. (This case involved aircraft which were not "instruments of commerce." They were involved in airborne geophysical surveys. The assessor was required to

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However, the taxpayer must prove that such substantial presence exists. Transitory contact, such as may occur when a vessel or aircraft makes a round-the-world voyage, does not establish substantial presence. Tax situs of the property would remain in California.

Example: Situs of Movable Property

Following is an example of situs determination using movable property owned by a taxpayer whose primary business location is outside of California. General rules of situs, as discussed thus far, were employed to make the determination.

Example 3.1: Out of state construction company

An out of state construction company worked on a two year gas pipeline project in California.

- The equipment did not leave California during the project.
- The equipment used on the project moved into ABC County in December 1996.
- The equipment used on the project moved out of ABC County in March 1997.
- It was typical that the equipment moved in and out of a county in less than six months.

Did the property establish situs in ABC County on the 1997 lien date, January 1?

Under Rule 205, the property established a taxable situs in California but did not establish a taxable situs in a specific county. (The property was not in transit, therefore Rule 203 does not apply.) The equipment moved frequently, but remained in California on the lien date and for a time period both before and after, although the equipment did not remain in any county long enough to meet the six month test required in Rule 205.

Situs in the appropriate county becomes dependent on article XIII, section 14 of the California Constitution; property is taxable in the county, city, and district in which it is situated or has situs. Thus, the property established a taxable situs in **ABC County, California** on the 1997 lien date.

SITUS OF LEASED OR RENTED PROPERTY (RULE 204)

Situs of leased equipment is determined not only on the basis of physical location of the property, but also on the intent of the owner. Determination of situs regarding this property is governed by Rule 204, *Leased Property*:

Property leased or rented on a daily, weekly or other short-term basis has situs at the place where the lessor normally keeps the property. Temporary absences from that location do not change the situs of the property.

apportion the value of aircraft physically abroad for all or substantial parts of the year, though domiciled in California.)

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1 The situs of property leased or rented for an extended, but unspecified, period or
2 leased for a term of more than six months shall be determined on the basis of the
3 lessee's use.

4 The intent of the lessor and the lessee as demonstrated by objective facts is the determining factor
5 in ascertaining the situs of leased or rented property. For example, property leased to a
6 contractor for a period of one month has situs at the lessor's location. It is clearly the intent of
7 both parties that the property return to this original location; this is its permanent and taxable
8 situs. However, where the contractor has leased the equipment for an unspecified period which
9 would appear to extend beyond six months, the equipment is taxable at its actual location on the
10 lien date.

11 Single Assessment For Leased Personal Property

12 When a property owner has multiple taxable items leased throughout a county, *precise* situs of
13 each lease becomes less important. Section 623 provides a new definition for situs by allowing
14 assessors to combine the multiple assessments for leased equipment, owned by the same lessor,
15 into one assessment. Section 623 states:

16 The assessor may place a single assessment on the roll for all leased personal
17 property in the county that is assessed with respect to the same taxpayer. Any
18 property assessed pursuant to this section shall, in the absence of evidence
19 establishing otherwise, be deemed to be located at the taxpayer's primary place of
20 business within the county.

21 A "primary place of business" is the taxpayer's headquarters, office, or facility within the county.
22 If the company has more than one facility within the county, the facility with the largest
23 equipment value is the situs which should be used for all leased equipment. In the absence of a
24 "primary place of business within the county", the location having the greatest value of a
25 company's leased equipment should be considered that company's primary place of business
26 within the county. On the other hand, if a company has an office, warehouse, or other "primary
27 place of business within the county", but has nearly all of its leased equipment located at a single
28 site in a different tax-rate area, that situs should be used for all of the company's leased
29 equipment in the county.

30 Section 623 only applies to leased personal property assessed to the same taxpayer. It does not
31 affect personal property that is not leased, and combining assessments in the manner authorized
32 by section 623 is strictly an option for assessors to use, not a requirement.

33 SITUS OF PROPERTY IN-TRANSIT (RULE 203)

34 Although property is normally taxable at the location where it has established permanent situs on
35 the lien date, what is the situs of property in transit on the lien date? The answer is determined by
36 the destination of the property, the legal owner on the property on the lien date, and the
37 application of Rule 203, *Property in Transit*.

DRAFT**Property Moving in Interstate or Foreign Commerce**

Property actually in transit on the lien date, to or from interstate or foreign destinations is exempt from taxation. However, it is important that the property actually be *in* transit to be exempt. Property that is otherwise taxable remains taxable until transit has commenced and may become taxable once again when transit has ended. For example, property being held or stored in railroad cars for the convenience of the owner is not in interstate transit even though it remains in the shipping cars. Property is not in interstate transit if the holding by the carrier is not incidental to its transportation.

Note that the exemption of property in interstate or foreign transit does not include instruments of commerce or property that has a permanent situs but is leaving or entering the state on a temporary basis as of the lien date. This exemption applies to property that is being moved from one established situs to another, such as equipment being shipped from a distribution warehouse to a retail store or otherwise being relocated from one factory to another.

Commencement of Transit

Transit commences when property has either started moving on its interstate or foreign journey or has been committed to a common carrier for that purpose. However, property deposited at the point of shipment in interstate commerce but not committed to a carrier is still subject to taxation.⁶³

Termination of Transit

In general, transit has terminated when the property reaches the hands of the owner at the destination point. Property brought into the state is taxable at the point transit ends. For property tax purposes, "reaching the hand of the owner" does not, however, always mean physically. For example, when the carrier becomes entitled to make storage, demurrage, or other charges for keeping the property or when the carrier acts as a warehouse by operation of law, the property is considered to have reached the owner. Likewise, when the owner is notified that property is available for unloading, it has reached the hands of the owner. If the holding of the property by the carrier is not merely incidental to its transportation, then the transit has most likely terminated.

Interruption of Transit

If the temporary suspension of the movement of the property is required in order to facilitate its transportation, to prevent its destruction, or to change the method of its carriage, it is still considered in transit and remains exempt. Property may be subject to taxation when the interruption in transit is for purposes unconnected with its transportation. Otherwise, it remains exempt. The courts have distinguished between suspension and termination of transit, stating:

Where property has come to rest within a state, being held there at the pleasure of the owner, for disposal or use, so that he may dispose of it either within the state,

⁶³ *Coe v. Error* (1886) 116 U.S. 517.

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or for shipment elsewhere, as his interest dictates, it is deemed to be a part of the general mass of property within the state and is thus subject to its taxing power.⁶⁴

Property Moving in Intrastate Commerce

Unlike property in interstate or foreign commerce, property remains taxable while in transit within California (in intrastate commerce). Taxable situs of this property among counties therefore becomes the issue.

Situs of Property Being Transported by an Owner

If an owner of property is transporting their own property on the lien date, the property has situs at the point of origin of the shipment regardless of the mode of transportation or the ownership of the means of conveyance.⁶⁵

Situs of Property Being Transported to a Buyer

Property being transported to a buyer has its situs at the point of destination unless the buyer demonstrates that the seller had title until delivery. If title transferred prior to delivery, it has situs at the point of origin.

Title transfer is normally an agreed upon item in the purchase agreement; property will be purchased and shipped "F.O.B. shipping point" or "F.O.B. destination". F.O.B. ("free on board") designates whether the seller or the purchaser will pay freight or transportation charges and determines when title transfers. "F.O.B. shipping point" means the purchaser is responsible for the property, and title transfers, at the point of origin (at the shipping point). "F.O.B. destination" means that title remains with the seller, and he/she bears the cost of transportation, until the property reaches its destination. The Uniform Commercial Code provides that the free on board (F.O.B.) designation, unless otherwise agreed between a seller and buyer, constitutes a term of delivery. Title to property remains with a seller until he has completed delivery by making the property available for disposition by the buyer at the F.O.B. point. Retention of a security interest by a seller must be disregarded for purposes of determining situs.⁶⁶ If questions arise regarding situs or assessee, a buyer may provide the purchase agreement or shipping agreement in order to demonstrate timing of title transfer.

Interruption of Transportation

As previously discussed, the interruption of transportation for purposes incidental to transportation does not remove property from its "in-transit status". However, the interruption of transportation for the business purposes or profit of the property owner terminates the transportation and generally creates a situs for taxation at the place where the property is situated on the lien date.⁶⁷

⁶⁴ *Minnesota v. Blasius* (1933) 290 U.S. 1.

⁶⁵ Rule 203(a)(1).

⁶⁶ Rule 203(a)(2).

⁶⁷ Rule 203(a)(2).

DRAFT**OTHER SPECIAL SITUS SITUATIONS****AIRCRAFT**

The guidelines for situs of aircraft depend on aircraft type. For property tax purposes, aircraft are typed or classed as *general aircraft*, *certificated aircraft*, and *air taxis*. Each is briefly defined below in order to properly discuss situs in relation to this property.⁶⁸

Definitions**General Aircraft**

General aircraft is any contrivance used or designed for the navigation of or for flight in the air which has been flown at least once.⁶⁹ It is not a parachute or similar emergency safety device, a rocket or missile, or a certificated aircraft or scheduled air taxi as defined below.

Certificated Aircraft

Certificated aircraft is aircraft operated by an air carrier or foreign air carrier engaged in air transportation while there is in force a certificate or permit issued by the Civil Aeronautics Board of the United States, or its successor, or a certificate issued by the California Public Utilities Commission authorizing such air carrier to engage in such transportation.⁷⁰

Air Taxi

Air taxi means aircraft used by an air carrier which (1) does not utilize aircraft having a maximum passenger capacity of more than 30 seats, (2) does not have a maximum payload capacity of more than 7,500 pounds in air transportation, and (3) does not hold a certificate of public convenience and necessity or other economic authority issued by the Civil Aeronautics Board of the United States, or its successor, or by the California Public Utilities Commission, or its successor.⁷¹ This definition can be further broken down to scheduled and unscheduled air taxis. Scheduled air taxis are treated similar to certificated aircraft and unscheduled air taxis are treated similar to general aircraft.

Situs of Aircraft**General Aircraft and Unscheduled Air Taxis**

General rules of situs apply to general aircraft as they do to other personal property.⁷² Situs is the location where the aircraft is habitually kept or to which it returns, when not in service.⁷³ When

⁶⁸ For a complete in-depth discussion and definition of aircraft types, see AH 570, *Commercial Aircraft and Assessors' Handbook* Section 577 (AH 577), *General Aircraft Assessment Procedures*.

⁶⁹ Section 5303.

⁷⁰ Section 1150.

⁷¹ Section 1154.

⁷² One exception is found in section 220, *Aircraft Being Repaired*. Out-of-state aircraft in California solely to undergo repairs are exempt from property taxation under this section even though they may be in California on the lien date.

⁷³ Rule 205(b).

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1 an aircraft substantially divides its time between two or more airports in California, situs
 2 becomes determinable based on a time test but no apportionment is necessary. Rule 205(b)
 3 states:

4An aircraft that spends a substantial amount of ground time at each of two or
 5 more airports has its tax situs at the airport where it spends the greatest amount of
 6 ground time.

7 If an aircraft establishes tax situs both in California and outside California, apportionment may
 8 be necessary and the rules established in *Ice Capades, Inc. v. County of Los Angeles* and
 9 *GeoMetrics v. County of Santa Clara* apply. That is, the assessment may need to be apportioned
 10 to eliminate that time the property spent outside the state by deducting all time that the aircraft
 11 has established tax situs outside California. The California assessment, in such a case, is based
 12 on the time actually in this state—at the airport where it spends the greatest amount of ground
 13 time—and all other time is allocable elsewhere.

Certificated Aircraft and Scheduled Air Taxis

15 Certificated aircraft and air taxis using airports within this state while engaged in interstate,
 16 intrastate, or foreign commerce are taxable for an apportioned value of the aircraft based on time
 17 in this state when tax situs has been established in California.⁷⁴ Specific statutes, sections 1150 -
 18 1156, govern the method of apportionment when tax situs is established here. To establish tax
 19 situs within California, intentional physical contact involving actual embarking or disembarking of
 20 crew, passengers, or freight must be made. Emergency contact does not, in and of itself, establish
 21 situs any more than does flying over the state without landing.⁷⁵ The apportioned value is
 22 justified, even though an instrument of commerce, by the fact that the taxing jurisdiction extends
 23 opportunities, benefits, and protection to the property (the aircraft) engaged in interstate or
 24 foreign commerce during the pro rata time that the property is physically present within that
 25 jurisdiction.⁷⁶

26 However, where an aircraft is foreign-owned, based, and registered, and serving California
 27 airports exclusively in foreign commerce, the state is precluded from taxation. No permanent,
 28 taxable situs has been established here and thus it is not taxable.

Aircraft Repair and Replacement Parts

30 Aircraft parts have situs where habitually located pursuant to Rule 201, in most circumstances,
 31 but aircraft components may occasionally acquire situs elsewhere. The following example
 32 identifies one of these situations.

33 An air carrier at all times rotates eight engines between storage, repair, and installation. Two
 34 engines are normally found at the place of storage, two at another location for repair, and four are

⁷⁴ *Flying Tiger Line, Inc. v. County Los Angeles* (1958) 51 Cal. 2d 314.

⁷⁵ Rule 202(b).

⁷⁶ See Rule 202(c) *Allocation Formula* and AH 570, *Commercial Aircraft Value Allocation*, for discussion of allocation formulas for various types of aircraft.

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installed in operating aircraft at any one time. The number of engines normally located at each location has situs and is assessable there.

VESSELS

A documented vessel shall be assessed at the place of documentation unless the place of documentation does not represent the situs of the vessel.⁷⁷ Nondocumented vessels are assessed where they are habitually moored when not in service.⁷⁸ As with aircraft, situs may depend on vessel type. Therefore, a brief discussion of vessel types and situs related to various vessels follows. More detailed information is provided in Assessor Handbook Section 576, *Vessel Assessment Procedure*.

Definition of Documented and Nondocumented Vessels

Vessels "include every description of watercraft used or capable of being used as a means of transportation on water."⁷⁹ These vessels are sub-defined as *documented vessels* and *nondocumented vessel* for property tax purposes.

A *documented vessel*, is defined by section 130, as

..any vessel which is required to have and does have a valid marine document issued by the Bureau of Customs of the United States or any federal agency successor thereto, except documented yachts of the United States, or is registered with, or licensed by, the Department of Motor Vehicles....

A *nondocumented vessel* is defined by exception in section 1141 as any vessel not required to be documented.

It is important to understand the meaning of both terms for the purposes of applying vessel situs statutes. The term *documented vessel* has a different meaning to non-property tax agencies. To the U.S. Coast Guard and the Department of Motor Vehicles (DMV), the term *documented* refers only to a vessel that is required to and does have a valid marine document issued by the U.S. Coast Guard and not to vessels licensed by DMV.⁸⁰ For property tax assessment purposes, however, the definition of *documented vessels* in section 130 includes all vessels required to be registered with DMV, as well as those documented with the U.S. Coast Guard. Therefore, to the appraiser, both U.S. Coast Guard registered vessels and DMV licensed vessels are *documented vessels* and are within the provisions of sections 130, 1139 and 1140.

Situs of Documented Vessels

A documented vessel shall be assessed at the place of documentation unless (1) the vessel owner has removed the vessel from the place of documentation to another location and has so informed

⁷⁷ Sections 1137-1141.

⁷⁸ Section 1141.

⁷⁹ Section 130(a).

⁸⁰ Vehicle Code Section 9840 sets forth a list of all types of vessels and prescribes which ones must be registered with DMV (and are thereby documented as defined by the assessor).

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the proper assessor in writing⁸¹ or (2) the assessor can show, despite either the place of documentation or the notice, that the vessel is permanently located in his/her county.⁸²

The county where DMV registered vessels are documented is the county of location on the registration certificate, the place of documentation. There are generally two addresses indicated on the registration certificate: the first showing the mailing address of the registered owner, and the second showing the location (situs) of the vessel where habitually moored. If the address shown as the owner's mailing address is the same as the address shown as the "habitually moored" location of the vessel, then the place of documentation is the address (or the domicile county) of the vessel owner. However, if the address shown as the "habitually moored" location is different from the owner's mailing address, then the place of documentation is the address (or the domicile county) of the vessel where it is habitually moored. In effect, the second address is considered the "written notice of its habitual place of mooring when not in service, to the assessor of the county where the vessel is documented," pursuant to section 1139.

For vessels documented with the U.S. Coast Guard, rather than DMV, no information is sent to the assessor other than that provided by the vessel owner on the property statement or marina or other source. Generally, the habitually mooring address shown on the property statement, per section 443, is the place of documentation for property tax purposes. If the assessor discovers unreported vessels located in the county for a period exceeding six months (Rule 205), the procedures sections 453 - 468 authorize the assessor several remedies for requiring the vessel owner to furnish the information on the property statement. If the vessel owner fails to comply or misrepresents the location or other information about the vessel, the assessor must estimate the value of the vessel (generally based on information obtained from the harbor master) and promptly assess the property as per sections 501 - 504.

In summary, there are a few instances when the place of documentation is not the place of habitual mooring. In such cases, the vessels should be assessed in the county where they are situated, per California Constitution article XIII, section 14. For example,

- The vessel was removed from the place of documentation to another location and has so informed the proper assessor in writing,⁸³ provided the information is verified by the county to which the vessel moved.
- An assessor can show, despite either the place of documentation or the notice, that a vessel is permanently located in his county,⁸⁴ provided the county of documentation indicated that the vessel is not assessed there.

⁸¹ Section 1139.

⁸² Article XIII, section 14 of the California Constitution ("...in the county... in which it is situated") takes precedence over provisions of sections 1139 and 1140 of the Revenue and Taxation Code.

⁸³ Section 1139.

⁸⁴ Article XIII, section 14 of the California Constitution.

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- The vessel is documented outside of this State, but travels regularly in California's waters, and the owners reside in this State.⁸⁵ Situs is determined based on permanent or "home port" situs. (See Situs for Sea Going Vessels.)

Situs Of Nondocumented Vessels

Vessels not required to be documented, either by DMV or the U.S. Coast Guard, shall be assessed where they are habitually moored when not in use.⁸⁶ For boats transported by trailers, the domicile of the owner is usually the place of habitual mooring and thus the tax situs.

Situs Of Intercounty Ferryboats

The tax situs of inter-county ferryboats is regulated by statute. When a ferry connects ports in more than one county, it is assessed in equal proportions in each of the counties. The wharves, storehouses, and stationary property ancillary to the ferryboat operation are assessed in the county or counties where they are located.⁸⁷

Situs Of Sea-Going Vessels

A sea-going vessel, which is normally documented, engaged in interstate or foreign commerce may constantly move between ports throughout the year. Due to the nature of interstate or foreign commerce and travel, physical presence may not establish permanent situs. Habitual or significant presence may be established at one or more locations. However, unlike other types of personal property, vessels are not subject to apportionment. When sites are temporary (see discussion of permanent v. temporary at the beginning of the chapter), even when habitual or significant presence is established, taxable situs is not acquired for property tax purposes. The permanent and thus taxable situs remains the port where the vessel receives "opportunities, benefits, and protection", normally the home port or port of registration. This is known as the "home port" rule.

The "home port" rule, established under common law and the Commerce Clause of the U.S. Constitution, article 1, section 8, clause, is a doctrine which permits vessels to be taxed at the port of registration or domicile of the owner.⁸⁸ It has limited application in modern times, but may be applied to sea-going vessels engaged in interstate or foreign commerce when no permanent situs has been established.

When the conditions listed above are met, the port of registration or "home port" may be considered the taxable situs of a sea-going vessel if "opportunities, benefits, or protection" are given the vessel at that place. As stated by the court in *San Diego County v. Lafayette Steel* (1985) 164 Cal.App.3d 690, and codified in the California Constitution article XIII, section 14,

⁸⁵ Section 1138.

⁸⁶ Section 1141.

⁸⁷ Section 1137.

⁸⁸ Vessels are required to be registered at the port nearest to the owner's place of domicile pursuant to U.S. Comp. Stats. 1901, p. 2808.

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The taxable situs of a vessel is not determined by the owner's designation of a home port but depends upon existence of sufficient contacts, such as the use and employment of the vessel within the jurisdiction and the opportunities, benefits, or protection afforded the vessel by the jurisdiction to satisfy due process.

Example: Situs Of Vessel

Following is an example of making a determination of taxable situs for a vessel using the sections and rules described above. The conclusion regarding situs is specific to the information given.

Example 3.2: Situs of Vessel

A taxpayer/vessel owner purchased a boat December 1, 1997, and registered it with the Department of Motor Vehicles (DMV) using a mailing address in XYZ County. On February 1, 1998, the taxpayer filed a vessel property statement with XYZ County using the same registration address as his mailing address and habitual place of mooring. However, on the back of the form, he noted that the boat was now moored in Mexico.

To determine proper situs and taxability, the assessor contacted the taxpayer and gathered the following information:

- The boat was purchased in San Jose on December 1, 1997.
- The boat was registered January 1, 1998, and the registration address (in XYZ County) shown was the domicile of the owner's son.
- The taxpayer claims (without documentation) that the boat has been habitually moored in Baja, Mexico since 2 days after acquisition. However, the situs address on the DMV registration certificate is the XYZ County residence of the owner's son.
- Taxpayer claims permanent domicile in the State of Washington.
- The state of Washington will not register vessels without a physical inspection.

Based on the facts provided, the taxable situs of this vessel on lien date January 1, 1998 is XYZ County for the following reasons (in order of importance):

- Application for a CF number and registration with DMV establishes situs for vessels; this taxable situs is XYZ County, since the taxpayer indicated an XYZ County address as both his mailing address and the place of habitual mooring on the registration for his vessel (section 1139). Under California law: "every undocumented vessel using the waters of this state shall be numbered." (Vehicle Code 9850). The taxpayer's intention was to use the boat in the waters of this state.
- The taxpayer stated on the property statement that the boat was located in XYZ County. This statement was signed under penalty of perjury. (The remarks on the back of the form are not sufficient documentation verifying a different situs for the vessel.)

If a vessel is (permanently) moved from the registered situs, an owner is required to notify DMV, by changing the address on the registration certificate. Since this was not done the situs of the vessel for property tax purposes is XYZ County.

DRAFT**1 SITUS OF LINEN SUPPLY**

2 Towels, uniforms, and other laundered linen are items normally supplied by linen supply
 3 companies.⁸⁹ For a monthly rental fee, the company supplies linen with the understanding that
 4 the items will be replaced periodically with a fresh supply. When soiled, the linen is taken back
 5 to the owner's business location for cleaning and redistribution. In general, these are exempt
 6 business inventory items when not on lease on the lien date.⁹⁰ However, if the lessee has a
 7 contractual right to a *specific quantity of linens* or *specific linens* (company uniforms, towels,
 8 etc.) and under the contract has a right to control the use of the linens, the *specific linens* are not
 9 eligible for the inventory exemption. They are committed to lease.

10 Taxable situs of linens must be determined based on the type and length of the lease involved
 11 pursuant to Rule 204 and 205. According to this rule, if the linens are rented on a short-term
 12 basis (less than six months or substantially shorter than the life of the property), they are to be
 13 assessed at the location where they are returned for cleaning. On the other hand, if the linens are
 14 rented on a long-term basis (six months or more, or for a major portion of the expected life), they
 15 attain a situs at the lessee's location. For example, laundries often lease readily identifiable
 16 industrial garments to service stations on a continuous basis. Often, these garments are
 17 temporarily taken to the laundry for normal maintenance and cleaning, but they are returned to
 18 the same user (lessee) where they are used until worn out. As such, these items are retained by
 19 the lessee for the major portion of their lives and attain a situs at the service station where they
 20 are used.

21 SITUS OF VENDING EQUIPMENT/GAMES

22 Vending machines (such as coin-operated pinball machines, food and drink vending machines,
 23 and music machines) are typically placed at various locations for extended periods of time and
 24 are only returned to the owner's business location for repair or for storage prior to disposal.
 25 Because these machines are more or less permanently situated at various locations, they have
 26 situs where located on the lien date.

27 CONTAINERS**28 Situs of Returnable Containers**

29 Compressed gas cylinders, beer barrels, and steel drums are types of containers that are typically
 30 delivered to locations where the contents are consumed and are then returned to the owners for
 31 refilling for reuse.⁹¹ A deposit may be required, but there is no intent to sell the containers. The
 32 situs of such containers is the location to which they are returned for reprocessing or refilling
 33 (i.e., the owner's business location).

⁸⁹ Similarly, linen supply hardware such as towel cabinets, soap dispensers, and soiled rag containers are supplied to remain at the customers' locations for the duration of the contract. Situs of these items is typically the lessee location based on general situs rules.

⁹⁰ Rule 133.

⁹¹ It should be noted that containers held for sale or lease are exempt from property taxation under the business inventory exemption. See section 129 and Rule 133.

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1 Where returnable containers originate from out-of-state and are returned to the out-of-state
2 location for refilling, the "average presence" rule set forth in *Sea-land Service, Inc. v. County of*
3 *Alameda* is applicable in determining tax situs.

Situs of Semi-Permanent Containers

5 There are various containers that are more or less permanently located at a particular site.
6 Examples are butane or propane tanks used for fuel storage. These tanks are refilled at the
7 respective locations and remain there for considerable periods. Situs for tax purposes is the place
8 where they are located on the lien date.

SITUS OF RACEHORSES

10 Section 5720.6 states that the tax situs of racehorses, subject to in-lieu taxation, is the home
11 ranch of the owner or other place where the racehorses are quartered or domiciled and to which
12 they normally return when not racing or in training at a race track. If the racehorses are not
13 quartered at a home ranch or other location when not racing or in training to race, the situs is the
14 residence of the owner. This determination is made at 12:01 a.m., on the lien date January 1,
15 each year.

SITUS OF PERSONAL PROPERTY OWNED BY MEMBERS OF THE ARMED FORCES

17 The Soldiers' and Sailors' Civil Relief Act provides that non-business personal property owned
18 by active duty service personnel has a tax situs in the state of the owner's legal residence.⁹²
19 Under this Act, a property's physical location may be California, but its taxable situs may be in
20 New York if the owner's legal residence is in that state. The personal property of a service
21 member who files a statement with the assessor declaring their legal residence to be in another
22 state is therefore exempt from taxation in this state.

⁹² Title 50 United States Code Annotated, Section 574.

DRAFT**CHAPTER 4: VALUATION OF PERSONAL PROPERTY**

AH 501, *Basic Appraisal*, includes a personal property chapter that gives a basic overview of the appraisal of personal property for property tax assessment purposes. Generally, as indicated in that chapter, basic appraisal principles apply to both real property and personal property. However, there are differences between the two.

This chapter focuses on basic and advanced valuation issues as related to personal property specifically. In order to discuss the topics in a complete manner, some review of information previously covered in other Assessors' Handbook sections is necessary.

REVIEW OF THE VALUE CONCEPT

Value is defined as the present worth of anticipated future benefits, or the monetary worth of a property at a given time. It is one of the most important and complex appraisal concepts. AH 501 includes a comprehensive discussion of the topic. This chapter discusses value as it applies specifically to personal property. Although the approaches to value are similar, real property and personal property differ significantly in that auditors appraisers must estimate the market value of personal property on the lien date every year. Annually, it must be taxed in proportion to its value as defined in section 110; "...the amount at which the property would be taken in payment of a just debt from a solvent debtor." Unlike real property, personal property is not governed by the limitations of Proposition 13.

The annual lien date value of personal property, which must reflect market value, probably will not be the same value as net book value (capitalized cost less depreciation) reflected on a taxpayer's books. Fair market value as defined by the appraiser and net book value as defined by the accountant are separate concepts. Any similarity is merely coincidental. It is important to recognize, as the courts have, the difference. The court has said,

The accountant deals with past historical cost to the present owner and by the process of amortization spreads the cost of property over its useful life. The unamortized cost reflected on the balance sheet has no relation to the "full cash value," i.e., the price that a willing buyer would pay a willing seller.⁹³

As mentioned above, an appraiser's concept of value (for personal property) is full cash value, or fair market value, or simply market value, as of the lien date. In contrast, the accountant's concept of value is normally the book value of the property; the capitalized asset acquisition cost less depreciation. This may or may not be the same as market value, as stated by the court in *De Luz Homes, Inc. v. County of San Diego*. In some cases, the "historical" cost basis for property tax purposes is different from what is recorded as the book cost of the asset. (Costs applicable to property tax assessment is discussed later in this chapter.)

⁹³ *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 567.

DRAFT**APPROACHES TO VALUE**

Rule 3, *Value Approaches*, which applies to both real property and personal property, discusses five approaches to value. Three of these approaches are normally used for property tax purposes: the replacement or reproduction cost approach, the comparative sales approach, and the income approach. In valuing personal property it is not always necessary, desirable, or even possible to utilize all three. An appraiser must analyze all available information to determine the most applicable and reliable approach(es).⁹⁴ An appraiser should have knowledge of each approach as it applies to personal property to make this determination.

Availability of data, most commonly data reported on the property statement, will most often dictate use of the cost approach. Therefore, the cost approach is given the most attention in this chapter. The comparative sales and the income approach are also discussed, but to a lesser extent, since they are utilized less often.

COST APPROACH

The cost approach is the method of valuation used most frequently to value personal property for property tax purposes because it lends itself to mass appraisal and is easily employed based on information provided on yearly property statements. As stated in Rule 6, this approach is particularly appropriate for property that is not over- or under-improved, and is not affected by other forms of depreciation or obsolescence. In other words, it is appropriate for most equipment.

Rule 3 allows and prescribes more than one type of cost approach that an appraiser may use. The three variations of the cost approach provided are: reproduction cost, replacement cost, and historical cost. Although an appraiser may not utilize each variation, general knowledge of the terms and concepts associated with each is important to have a thorough understanding of value in the context of property tax appraisal.

Reproduction Cost Approach

The reproduction cost approach, as a variation of the cost approach, has limited usefulness because it uses *reproduction cost* (the cost to replace an existing property with an identical property, a replica) as a basis for estimating value. It is frequently not possible or desirable to duplicate an existing property, due either to the lack of certain materials or trade skills or the functional obsolescence of a property.

The difficulty of using reproduction cost increases as a property ages. When a property would not be exactly duplicated, as is often the case, reproduction cost loses validity as an indicator of market. This lack of validity can be overcome if depreciation is accurately estimated, but this can be somewhat difficult to determine for an exact replica.

⁹⁴ Rule 3; *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546.

DRAFT**Replacement Cost Approach**

Replacement cost is the cost to replace an existing property with a property of equivalent utility as of a particular date. The replacement cost concept is the most meaningful as far as the principle of substitution is concerned. In the replacement cost approach, elements of a property that would clearly not be included in a substitute of equal utility are excluded from the estimated replacement cost.

Historical Cost Approach

Historical cost reflects the level of cost at the time of a property's original construction or acquisition. Historical, or original, cost appears in Rules 3 and 6 in two contexts: (1) as a method of estimating reproduction cost or replacement cost and (2) as the *historical cost/historical cost less depreciation approach* used in the valuation of rate-regulated properties. The first is applicable to any property whose earning or benefits are not regulated based on historical cost; that is, the assessor may use historical or original cost as a method of estimating reproduction or replacement cost new using price indexes or data on current prices for similar property. (The estimate must then be reduced by the amount of estimated depreciation to arrived at an indicator of fair market value.)

The second is applicable only to investor-owned regulated public utilities. The *historical cost/historical cost less depreciation approach*, as stated in (2) above and referred to in Rule 3(d), is a variation of the cost approach frequently applied to investor-owned, regulated public utilities. The approach has little application to the county assessor and is not discussed in this manual.

The reproduction cost approach and the replacement cost approach are the variations most commonly used to value property at the county level. In general, these variations of the cost approach use historical or original cost⁹⁵ information to estimate a current cost to replace or reproduce a given property, or to estimate value. Using index factors, or another means as appropriate, reproduction cost new (current cost new to reproduce an *identical* property) or replacement cost new (current cost new to replace a property with a *similar* property of the same utility) is determined. Then, the reproduction or replacement cost is adjusted to reflect depreciation to arrive at an assessable value (the current cost to replace or reproduce a given property). AH 582, *Derivation of Index Factors* and the yearly update of AH 581, *Equipment Index and Percent Good Factors*, discuss this procedure in detail and provide suggested index factors and percent good tables for appraisers' use.

To use the factors and valuation method contained in the Assessors' Handbook, an appraiser must estimate a full economic cost (replacement cost new or reproduction cost new), estimate all forms of depreciation that apply to a particular property, and be aware of the limitations inherent to this approach. If estimates are not made with reasonable accuracy, the resulting value will not reflect an accurate estimate of full cash value, or market value. It is important for an appraiser to

⁹⁵ Rule 6 uses the terms historical cost and original cost synonymously, the cost of the property when new. The term *acquisition cost* is, in the Rule, used as the cost to the current owner. For purposes of this manual, the terms are used as defined in Rule 6.

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realize the limitations of the approach in regard to a specific property because adjustments may need to be made, or a different approach to value utilized. Cost components, depreciation, and the limitations of the cost approach are discussed below.

Valid Cost Components

In the determination of cost for property tax purposes, whether real property or personal property, it is important to include all appropriate cost components and exclude all inappropriate cost components. A property's recorded purchase price does not necessarily include all costs required to estimate value for property tax purposes, and nor does it necessarily exclude costs which do not contribute to value. In other words, not all costs contributing to value are booked and not all costs booked contribute to value. For example, the booked cost may represent acquisition cost as opposed to historical cost; acquisition cost being the current cost to the current owner, and historical cost being the original cost when new. If the cost to the current owner or book cost does not accurately reflect all valid cost components or market value at the time they purchased the property,⁹⁶ resulting replacement cost new and value estimates using the index factors and percent good factors respectively will not be good indicators.

Thus, it is important to be aware of all cost components. Rule 6 defines these costs as including labor, material, entrepreneurial services, and interest on borrowed or owner-supplied funds. Rule 6 also includes in that list "other costs typically incurred in bringing the property to a finished state (or to a lesser state if unfinished on the lien date)." These *other costs* necessary to bring the property to a *finished state* may sometimes cause disputes. *Other costs* include indirect costs that can be difficult to allocate and even more difficult to identify in some cases. Also included, as *other costs*, can be entrepreneurial profit and trade-level costs (or adjustments). *Finished state* may be controversial also because equipment can be used at different levels; for example, at production, distribution, and consumer levels. (The term *finished state* also relates to entrepreneurial profit and trade level.)

Direct and Indirect Costs

Cost for appraisal purposes may be thought of as *full economic cost*. Full economic cost should include all market costs necessary to purchase or construct equipment and make it ready for its intended use. Thus, all costs, direct and indirect, associated with putting equipment into use should be included in the cost. *Direct costs*, or "hard" costs, are expenditures for the labor and materials required to construct the property (whether purchased in the form of raw materials or a finished product). *Indirect costs*, or "soft" costs, include expenditures other than labor and material necessary to put the equipment into use.

The following listing illustrates typical costs which should be included in full economic cost, that is, those costs required to put the equipment to use. Some of the more common items are discussed in more detail in the pages following the table. These costs may be equal to, or more than, the cost to put the equipment in place. For example, scientific equipment in place, but not

⁹⁶ *Dennis v. County of Santa Clara* (1989) 215 Cal.App.3d 1019.

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- 1 tested and debugged, is not usable. Testing and debugging are therefore included in the full
 2 economic cost.

Table 4A: Valid Cost Components

<u>DIRECT COSTS</u>	<u>INDIRECT COSTS</u>
<ul style="list-style-type: none"> • Purchase Price including sales tax, freight, and installation--(with all features & attachments)⁹⁷ • Costs for self-constructed equipment <ul style="list-style-type: none"> • Materials • Labor used in construction • Cost of equipment used in construction • Materials storage facilities • Profit and overhead 	<ul style="list-style-type: none"> • Unbooked Sales/Use Tax⁹⁸ • Freight-in⁹⁹ • Installation (foundations, pilings, utility connections, trial runs, debugging) • Trade-In Allowances • Interest on borrowed or owner supplied funds (for construction; finance charges for purchase are not components of cost) • Machine Validation and Evaluation: Testing and debugging • Trade-level and Entrepreneurial profit¹⁰⁰ • Indirect Labor (construction supervision, engineering fees, administration, etc.) • Other Applicable Costs

3

4 Purchase Price

- 5 The Revenue and Taxation Code permits the assessor to presume fair market value from a
 6 property's purchase price, but does not bind the assessor to rely upon it.¹⁰¹ The assessor must
 7 determine whether the purchase price accurately represents market value at the time of

⁹⁷ Purchase price is total consideration whether money or otherwise ; section 110.

⁹⁸ *Xerox Corporation v. County of Orange* (1977) 66 Cal.App.3d. 746; *County of San Diego v. Assessment Appeals Bd. No. 2* (1983) 140 Cal.App.3d. 52.

⁹⁹ Ibid.

¹⁰⁰ *Beckman instruments, Inc. v. County of Orange*, (1975) 53 Cal.App.3d. 767.

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acquisition. If evidence shows that purchase price is not a good indicator of value, it should not be used.¹⁰²

Sales/Use Tax, Freight, and Installation

The general rule in determining market value is that where price is the basis of value, sales/use tax, freight, and installation cost are elements of that value.¹⁰³ These elements should be included in full economic cost since they are part of value when they are paid. However, if these costs would have been applicable to a similar consumer using the equipment at a similar *trade level* they may be assessable even when not paid.¹⁰⁴ The costs apply at the same rate that would apply to that similar consumer whether actually paid or not.

However, there are exceptions to the general rule. Equipment rented to federal instrumentalities and aircraft used by common carriers (neither of which are subject to sales tax), for example, are valued without sales tax as an element of value. The reason in both cases is that the consumer (the federal government or air carrier) is never liable for sales tax on purchases of such equipment. Consequently, the replacement cost should not include sales tax, unless or until the property is put to private use or rented to a private party. The principle is that when a taxpayer lawfully pays sales tax at a rate below normal, the amount actually paid is the appropriate amount to be included as an element of value as long as the circumstances that created the special rate continue.

Trade-In Allowances

In some cases, a buyer will pay for property in part or in whole with a trade-in of older property or equipment. This is a *trade-in allowance* and an element of value when using the cost approach. This allowance is part of the price paid for the property, although the price was not paid in cash. Had the trade-in allowance not been accepted as payment, the cash price would have been higher. Appraisers must, therefore, add-back any trade-in allowances subtracted from the purchase price or booked cost.

Capitalized Interest/Interest During Construction

Self-constructed property, property constructed by the user and put to productive use in that business, have an interest cost associated with them regardless of whether the source of funds is debt or equity and whether or not the interest is actually incurred. Therefore, an increment of interest must be identified and included when valuing self-constructed (or self-financed)

¹⁰¹ *Dennis v. County of Santa Clara* (1989) 215 Cal.App.3d 1019.

¹⁰² Section 110(b) discusses use of purchase price in relation to valuation of real property. This section can be applied to personal property where appropriate.

¹⁰³ *Xerox Corp. v. Orange County* (1977) 66 Cal.App.3d 746.

¹⁰⁴ Property must be valued at the level situated on the lien date. This is the trade level concept. Thorough discussion of this topic is included later in this chapter.

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property.¹⁰⁵ The purpose is to include interest costs that would be incurred in the typical construction of the property, but not interest incurred during long-term financing.

When identifying the cost of capital rate to apply, the following criteria should be considered:

- The rate derived should be the typical rate for the specific industry group of the taxpayer.
- The rate should be the weighted average cost of capital, taking into consideration the typical debt-equity ratio for the industry.
- The cost of debt for long-term capital projects in most industries typically relates to long-term bonds, rather than short-term prime rate borrowing.
- Interest cost is related to and measured against the typical pattern for use of funds on any given project.

Example 4.1: Computing Capitalized Interest								
<p><u>FACTS:</u></p> <ul style="list-style-type: none"> • A candy company constructed candy manufacturing equipment. The construction activity started on March 1, 1997, and the equipment was ready for use on December 1, 1997 (a nine month acquisition period). • On March 1, 1997, at the beginning of construction, the company borrowed \$400,000 at 15% for five years to pay for the parts and material acquired for use in construction. <p>What is the interest cost component necessary to include when using the cost approach to value?</p> <table style="width: 100%; border: none;"> <tr> <td style="padding-bottom: 10px;">Funds Borrowed to Begin Construction x Interest Rate x Time</td> <td style="width: 15%;"></td> </tr> <tr> <td style="padding-bottom: 10px;">$\\$400,000 \times 0.15 \times 9/12$</td> <td style="text-align: right; vertical-align: bottom; background-color: #cccccc; padding: 5px;"><u>\$ 45,000</u></td> </tr> </table> <p>What is the Total Original Cost of the Equipment (based on the information provided)?</p> <table style="width: 100%; border: none;"> <tr> <td style="padding-bottom: 10px;">Funds Borrowed to begin Construction + Cost During Construction</td> <td style="width: 15%;"></td> </tr> <tr> <td style="padding-bottom: 10px;">$\\$ 400,000 + 45,000 =$</td> <td style="text-align: right; vertical-align: bottom; background-color: #cccccc; padding: 5px;"><u>\$ 445,000</u></td> </tr> </table> <p><i>Note: No interest cost is capitalized after the equipment is placed in use on December 1, even though interest continues to accrue on the \$400,000 loan for the acquisition of parts and material needed for the construction of the equipment.</i></p>	Funds Borrowed to Begin Construction x Interest Rate x Time		$\$400,000 \times 0.15 \times 9/12$	<u>\$ 45,000</u>	Funds Borrowed to begin Construction + Cost During Construction		$\$ 400,000 + 45,000 =$	<u>\$ 445,000</u>
Funds Borrowed to Begin Construction x Interest Rate x Time								
$\$400,000 \times 0.15 \times 9/12$	<u>\$ 45,000</u>							
Funds Borrowed to begin Construction + Cost During Construction								
$\$ 400,000 + 45,000 =$	<u>\$ 445,000</u>							

Note: No interest cost is capitalized after the equipment is placed in use on December 1, even though interest continues to accrue on the \$400,000 loan for the acquisition of parts and material needed for the construction of the equipment.

Validation Costs of Machinery and Equipment

Validation cost is a term often used in the pharmaceutical industry, although it can be associated with other types of manufacturing companies. *Validation costs* are those incurred in the testing process of the production line. Some of these costs may be assessable.

¹⁰⁵ Rule 6.

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When equipment on a production line is constructed, part of the cost during construction is the testing of the equipment. In other words, cost incurred to determine if the equipment is functioning and performing as designed. These costs, incurred in the process of verifying that the production line is working correctly, are *machinery validation costs*. They are part of the installation process and are necessary in bringing the property to a finished state. Machinery validation costs are assessable as valid cost components.

Product validation costs, on the other hand, are costs incurred in the research and development stage of a product, rather than in the construction of the equipment. Product validation costs are not assessable. They are part of inventory (part of the product), but have nothing to do with equipment. In terms of the pharmaceutical industry for example, *product validation costs* would be incurred in the laboratory when a drug (the product) is developed.

Research and Development Costs

Research and developments costs (R&D) are costs incurred during development. Similar to validation costs, they are appropriate concerns of the assessor when they relate to machinery or other assessable property, particularly when determining the proper trade level for self constructed equipment.

In the development of machinery, a certain amount of research costs are involved in the production of the first piece of equipment of its kind; costs that may not be incurred with succeeding machinery similarly constructed. Even though associated with the one piece of equipment, the first prototype, these costs should be allocated to all of the equipment manufactured as a result of the research on the initial product. Costs incurred to produce the prototype benefited the manufacturing of additional units and is thus applicable to their value.

Trade Level

Consistent with the definition of full cash value, property must be assessed at the proper level of trade based on its location and use on the valuation date (the lien date). An appraiser must recognize that property normally increases in value as it progresses through production and distribution channels whether or not the cost or value added is booked.

The trade-level concept is applicable when book cost does not provide adequate information for making a fair market value appraisal. It is a cost component which is most frequently applicable to leased equipment and self-constructed equipment. Rule 10, *Trade Level for Tangible Personal Property*, outlines and describes the different levels of trade and explains trade level as follows:

In appraising tangible personal property, the assessor shall give recognition to the trade level at which the property is situated and to the principle that property normally increases in value as it progresses through production and distribution channels. Such property normally attains its maximum value as it reaches the consumer level.

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Under the provisions of the rule, personal property is assessed on the basis of how it is held or used on the lien date rather than at the book cost of the owner. In effect, the rule provides for equal value for properties equally situated.

This concept is more easily understood using the example below borrowed from AH 501, *Basic Appraisal*.

Example 4.2: Trade Level
<p><u>FACTS:</u></p> <ul style="list-style-type: none"> • ABC Grading Company purchases a bulldozer for \$250,000 and uses it to prepare land for subdivision development. • At the same time, Dozer Sales, a bulldozer dealer, purchases an identical bulldozer for \$200,000 (dealer's cost) and rents it on a one-year lease to JKL Grading Company. JKL uses the bulldozer to prepare land for subdivision development, in competition with ABC. • Concurrently, the bulldozer manufacturer (GHI) provides an identical bulldozer to its subsidiary, RST Grading Company (a competitor of ABC and JKL). The manufacturer's cost is \$150,000. RST uses the bulldozer to prepare land for subdivision development, in competition with ABC and JKL. <p>Logically, the assessable cost for each piece of equipment should be the same. In each situation, the bulldozer is used for the same purpose or at the same trade level. If no trade level adjustment were used and the book costs were used as the sole basis for appraising, the assessments would not be the same; they would be substantially different. The trade-level principle, per Rule 10, allows the assessor to achieve fair market value for the three machines and provide uniformity of assessment.</p> <p>Based on the information above, Dozer and GHI's costs would require two different trade-level adjustments to arrive at the \$250,000 (consumer level) value. Dozer's cost (\$200,000) is a dealer cost which would not include retail items such as sales tax and the dealer's profit margin. GHI's cost (\$150,000) is the manufacturer's cost which does not yet include retail items missing from the dealer cost, plus items such as profit margin normally added in when the manufacturer sells the product to either the dealer or a retailer. In this case, the dealer cost is adjusted 125% ($\\$250,000 / \\$200,000$) and the manufacturer's cost is adjusted 167% ($\\$250,000 / \\$150,000$) to arrive at the proper trade-level.</p>

Basically, as seen above, the trade-level concept allows for adjustments based on what a normal consumer at that level would pay. If another consumer of like property at that level of trade would be subject to a cost (i.e., sales tax), the full economic cost should include that cost component whether or not the cost was actually incurred. In *Xerox Corporation v. County of Orange*, 66 Cal.App.3d 746,¹⁰⁶ the Court indicated that under the market value concept, where

¹⁰⁶ Decision supported in appeal, *County of San Diego v. Assessment Appeals BD. No. 2.*, (1983) 140 Cal.App.3d 52.

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price is the basis of value, the sales tax and freight charges are elements of value. Consumer trade level includes sales tax, freight and installation charges and the property is valued in accordance with the comparative sales, cost or income method. The courts have also supported the trade level concept by allowing inclusion of a markup in value for interdivisional transfers of manufactured goods for purposes of delivery or to facilitate marketing.¹⁰⁷

The following table simplifies the application of the trade level principle:

Example 4.2 (continued): Trade Level			
	ABC Grading	Dozer Sales	GHI Manufacturer
Manufacturer's Cost (cost incurred to produce equipment, costs incurred to bring equipment to finished state)			\$150,000
+ Value Added as Moved to Next Trade Level (mark up to include profit to manufacturer)			<u>50,000</u>
Dealer's Cost		\$200,000	\$200,000
+ Value Added as Moved to Next Trade Level (mark up to include profit to dealer, sales tax, freight, installation, and other necessary charges)		50,000	50,000
Consumer Level Cost / Assessable Cost	\$250,000	\$250,000	\$250,000

In practice, determination of a trade-level adjustment may be more complex because of (1) uniqueness of the equipment, (2) the infrequency of sales, and (3) the unavailability of facts necessary to determine its marketability on the lien date. To simplify the process, keep in mind the example provided here and first determine how the property is actually held or used on the lien date.

In gathering data to determine a proper trade level adjustment, the use of a property prior to and after the lien date should be considered since it may influence how it is valued on the lien date. For example, if a lessor of copy machines uses a copier before and after the lien date but places the copier in its inventory on the lien date, that copier is properly classified as assessable equipment at the consumer level. The value of the property is based on the level at which it is held or used on the lien date.

Include all costs necessary and appropriate for the property's trade level, and make adjustments for any discounts that may be appropriate. For example, if the consumer is a large company that

¹⁰⁷ *Beckman Instruments, Inc. v. County of Orange* (1975) 53 Cal.App.3d 767.

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typically receives quantity discounts due to the amount of equipment purchased, it may be appropriate to reflect such a discount in the adjusted cost (see also *Discounts/Adjustments* below).

To determine appropriate adjustments, information should be gathered from available sources (which may include review of accounting records to determine normal profit margin added at each level, review of cost guides, and gathering of information from equipment dealers). For any given situation, information gathering relevant to cost is an important part of the process and value estimate.

While the trade level principle is most frequently relevant when assessing leased and self-constructed equipment, it is also important regarding other property where book cost is not indicative of costs generally incurred by the market considering the location and use of the property. However, caution must be exercised when applying the trade level principle. Consider the rental of the bulldozer by Dozer Sales to JKL Grading Company in Example 4.2. If the rental had been for less than six months (short-term lease) instead of the one-year lease specified in the example, Rule 10 directs that the bulldozer shall be assessed at Dozer's acquisition value (\$200,000 dealer cost) instead of the \$250,000 consumer-level cost. The lessor would then be considered the consumer pursuant to subdivisions (d) and (e) of Rule 10.

Trade level is an important concept for the appraiser to remember, although it may not frequently be applied. The Business Property Statement requests that taxpayers report costs at the proper trade-level;¹⁰⁸ therefore, an appraiser may not encounter trade-level adjustments unless an audit is done. During the course of an audit especially, an auditor appraiser should verify that costs are reported at the proper trade level, and that the adjustment is appropriate.

Discounts/Adjustments

The purchase price of equipment may reflect discounts allowed due to payment within a pre-determined period, or due to the quantity purchased. For example, a seller may offer a discount (say 2 percent) if the equipment is paid for in-full within a short time (say 30 days). If the purchaser takes advantage of this discount and pays timely, the booked value of the asset would reflect the discount. It may also reflect rebates and income tax credits.

Discounts and rebates offered by a seller are a normal part of supply and demand in the process of setting market value, where the prudent buyer pays as little as reasonably possible and the seller charges as much as possible. The price paid for the property after recognition of discounts and rebates represents the amount received by the seller as well as the cost to the buyer.¹⁰⁹ These types of adjustments to purchase price are allowable for property tax purposes.

¹⁰⁸ Rule 10.

¹⁰⁹ The price paid by the buyer may include a sales tax component. Sales tax is not part of the compensation retained by the seller.

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Income tax credits, by contrast, are simply reductions of federal income tax liability. They are similar to depreciation or amortization charges against income for income tax purposes. Other allowances that are treated similarly to income tax credits include energy tax credits and manufacturers' investment credits. These types of adjustments to purchase prices are not allowable for property tax purposes.

The following chart is an outline of types of adjustments discussed above and the proper treatment for property tax purposes.

Table 4B: Discounts/Adjustments		
Description	Adjustment allowed for property tax purposes	No adjustment allowed for property tax purposes
Quantity discount	X	
Cash discount	X	
Rebates	X	
Income Tax Credits		X
Energy Tax Credits		X
Manufacturers' Investment Credit		X

Other Applicable Costs

Other costs, whether booked or otherwise, should be considered on an individual basis in relation to how they affect a property's market value. Other costs may include, for example, those incurred in a major overhaul of a piece of equipment. If an overhaul extends the life of an asset or increases its utility, the value of the asset may be affected. (This should not be confused with minor repairs and maintenance required to continue the existing use of a piece of equipment; these costs do not represent assessable property.) The costs associated with a major overhaul may be expensed or may be booked as a capitalized asset. In any event, it is important to consider major overhaul costs in the valuation of equipment.

Depreciation of Machinery & Equipment

Depreciation, for appraisal purposes, is a loss in value from any cause. It is the difference between the value of a hypothetical new, similar property and the current value of the subject property; the total measure of the reduced value at a particular point in time. In other words, it is a by-product of the value estimate.

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For appraisal purposes, depreciation is also a decrease in utility. The decrease in utility occurs in two different ways. First, and probably most important, the remaining economic life of a property may decline. Instead of yielding benefits for ten years as when new, a property may now have only eight years remaining service. Second, there may be a reduction in net benefits from the property. Fewer benefits may be provided, or the same benefits are provided at a higher cost (thus, fewer net benefits are provided). Thus, a decline in the remaining life or the efficiency of property causes depreciation.

An appraiser's definition and use of depreciation is fundamentally different from the accountant's definition and use of depreciation, as discussed earlier regarding value. The accountant uses depreciation to amortize a property's cost over the life of the property. Each year the accountant estimates depreciation, based on a preselected life, to recover the cost of the equipment in the most beneficial legal manner for income tax purposes.

These definitional differences are represented mathematically below:

$$\text{Replacement Cost New} - \text{Depreciation} = \text{Current Market Value} \quad (\text{Appraiser})$$

$$\text{Capitalized Cost} - \text{Depreciation} = \text{Book Value} \quad (\text{Accountant})$$

The appraiser cannot use the accountant's depreciation estimate when valuing an asset because they must determine an estimate of depreciation which directly relates to the actual loss in value the property has incurred. Accountants are not concerned with representing market value at any point in time, but are concerned only with writing off the cost incurred to purchase the asset. If book value (capitalized cost - depreciation = book value) has any relation to market value, it is only coincidental. Rather than using depreciation computed for accounting purposes as an estimate, appraisers should use methods of estimating depreciation that represent the loss in value a property has suffered.

Although depreciation may be, and most often is, estimated in a lump sum, it is important to be aware of each type of depreciation in order to determine (1) if all necessary adjustments have been made and (2) that there are no duplicate allowances for any one type. Each type of depreciation: physical deterioration, functional obsolescence, and external obsolescence, is defined and discussed below.

DRAFT**Types of Depreciation Defined**

A property may suffer from one or more forms of depreciation. That is, a single piece of equipment may contain elements of physical deterioration as well as both functional and external obsolescence. It may be impossible to categorize the amount of depreciation attributable to each cause, but recognizing and identifying the types applicable to a property may aid in estimating total depreciation to arrive at value.

Physical Deterioration

Physical deterioration is the loss in value which may be the result of wear and tear either from use or exposure to various elements. This type of depreciation is expected on most equipment. Virtually all properties deteriorate as they age, and it is not abnormal unless equipment is put to excessive use or misused. Good maintenance will slow the process, while lack of maintenance and overuse will increase physical deterioration.

Most physical deterioration can be corrected. However, the relationship between the costs involved and the economic benefit derived determines whether it is economically feasible to correct or repair physical deterioration. An element of physical deterioration is considered *curable* when the cost to correct the deficiency is less than the economic benefit resulting therefrom. When the cost to correct the deficiency is greater than the resulting economic benefit, the element of physical deterioration is considered *incurable*.

Functional Obsolescence

Functional obsolescence is the loss of value in a property caused by the design of the property itself. When the capacity of a property to perform the function for which it was intended declines, functional obsolescence begins. It may be attributable to such things as: changes in taste in the marketplace; changes in equipment design, materials, or process; and poor initial design.

Changing technology commonly creates functional obsolescence for personal property, and some functional obsolescence can be or should be considered normal to varying degrees (depending upon the industry and equipment type). Older machines and sometimes newer machines or entire lines of equipment, even though still in use, may be made obsolete by new technologies and manufacturing processes and the market value may be reduced because of functional obsolescence.

Functional obsolescence may be less tangible or visible than physical deterioration, but it may be more significant. However, it may be curable. An element of functional obsolescence is considered *curable* when the cost to correct the deficiency is less than the resulting economic benefit. When the cost to correct the deficiency is greater than the resulting economic benefit, the element of functional obsolescence is considered *incurable*.

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1 ***External Obsolescence***

2 External obsolescence, also known as economic obsolescence, is a loss in value resulting
 3 from adverse factors external to the property that decrease the desirability of the property.
 4 This type of depreciation includes the loss of value due to: inflation; high interest rates;
 5 legislation; environmental factors; reduced demand for the product; increased competition;
 6 changes in raw material supplies; and increasing costs of raw material, labor or utilities
 7 without a corresponding price increase of the product.

8 Loss in value attributable to external obsolescence is usually beyond the owner's control
 9 and is mostly atypical depreciation. It can be identified by studying the overall market
 10 conditions for a property. For example, if the output of a machine is superseded in the
 11 marketplace by output of a different material (i.e., fiberglass for metal or plastic for
 12 wood), and the market no longer absorbs the superseded output, then the machinery has
 13 suffered external obsolescence.

14 **Typical v. Atypical Depreciation**

15 *Typical depreciation* is that depreciation which is expected for that particular type of property.
 16 Typical depreciation for most kinds of machinery and equipment can be determined using the
 17 percent good factors supplied yearly in AH 581, *Equipment Index and Percent Good Factors*.
 18 *Atypical depreciation*, on the other hand, is unexpected depreciation. Atypical depreciation may
 19 be estimated separately using other methods of calculation in combination with percent good
 20 factors or as a completely separate calculation in itself.

21 **Methods of Estimating Depreciation and Value**

22 There are several methods of estimating depreciation for appraisal purposes. Appraisers may
 23 need to use one or more of these methods while determining depreciation from all causes. Again,
 24 the appraiser's methods are not the same as the accountant's methods because an accountant uses
 25 depreciation to recover cost over a preselected useful life of the property while an appraiser uses
 26 depreciation to estimate market value.

27 ***Equipment Index Factors and Percent Good Factors***

28 Estimating loss in value, depreciation, to determine (market) value of personal property for
 29 property tax purposes most often involves a mass appraisal method. The property statement is
 30 organized to facilitate use of such a method, specifically use of equipment index and percent
 31 good factors. Property (normally equipment) is valued based on information reported on
 32 property statements. Each piece of equipment is not identified and valued separately, but rather,
 33 the equipment is valued as a group based on the type of business and description of the
 34 property.¹¹⁰ The first step in the calculation process is to "trend" the historical cost of the
 35 property to an estimated replacement cost new. This trending is accomplished using equipment
 36 index factors (cost x index factor). The next step is to multiply the trended historical cost by a

¹¹⁰ An exception is Form AH 571-F (Agricultural Property Statement). Each piece is listed separately on this form. See Chapter 7 for a complete discussion of property statements.

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percent good factor to estimate the market value of the property, replacement cost new less normal depreciation (RCNLD).

As explained in AH 581, *Equipment Index and Percent Good Factors*, and AH 582, *The Explanation of the Derivation of Equipment Percent Good Factors*,¹¹¹ equipment index factors and percent good factors are computed and published by the Board for use in estimating replacement cost new and equipment value respectively. These tables, provided in AH 581, are based upon data for different types of property and have validity to the extent that a subject property has experienced usual, expected depreciation for its age and type. They are meant to reflect normal depreciation, which includes typical physical deterioration and normal functional obsolescence, and external obsolescence.

A discussion of the factors, the equipment index factor and the percent good factor, is included here in a general context. It not meant to represent a study of the topic, but rather an overview to facilitate application of the factors. For more information, refer to AH 581 and AH 582.

Equipment Index Factors

Equipment index factors are developed for use in mass appraisals and are generally reliable and practical for converting historical or original cost to estimates of reproduction cost new or replacement cost new for mass appraisal purposes. The index factors recommended by the Board, updated and distributed yearly in AH 581, include three separate index factor tables: (1) commercial equipment, (2) industrial equipment, and (3) agricultural and construction equipment. Additionally, the Board staff provides tables to be used in the valuation of computers, related equipment, and semi-conductor equipment; and state assessed properties.¹¹²

The majority of the index factors published and provided by the Board are designed to estimate replacement cost new as opposed to reproduction cost new since the items included in the compilation of the indexes are replacement items. The commercial equipment index factors (Table 1) provided in AH 581 are compiled on the basis of equipment price level change data published by Marshall & Swift Publication Company in their comparative cost indexes listed in *Marshall Valuation Service*. These are indexes designed "for quick computation of present **replacement costs** from dependable historical costs."¹¹³ Similarly, the industrial machinery and equipment index factors (Table 2) and the agricultural and construction equipment index factors (Table 3) are derived using the Bureau of Labor Statistics producer prices and the Producer Price Index as a basis. "The Producer Price Index measures average changes in selling prices received by domestic producers for their output."¹¹⁴ In developing the indexes, the Bureau of Labor Statistics reflects certain quality adjustments in the prices but does not make adjustments for minor quality adjustments to products.

¹¹¹ AH 581A renumbered as AH 582 (1997).

¹¹² Valuation tables for computer related and semi-conductor equipment are updated and distributed via Letter to the Assessor (LTA). Index factors for state assessed properties are available upon request.

¹¹³ Marshall & Swift Publication, *Marshall Valuation Service*, Sec. 98, p. 1, January 1997.

¹¹⁴ U.S. Department of Labor Bureau of Labor Statistics, *BLS Handbook of Methods*, 130.

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1 ...When a company respondent reports a price that reflects a physical change in a
 2 product, the Bureau uses one of several quality adjustment methods. The direct
 3 comparison method is used when the change in the physical specification is so
 4 minor that no product cost differences result; in this instance, the new price is
 5 directly compared to the last reported price under former specifications, and the
 6 affected index reflects any price difference.¹¹⁵

7 Thus, the indexes generally reflect replacement cost. If further adjustments are made for
 8 technological or design improvements, reproduction cost new may be the result of the application
 9 of the indexes to historical or original cost¹¹⁶

10 When selecting and applying these factors, it is important to properly identify the type of
 11 business and (classification of) equipment subject to appraisal. Different index factors and tables
 12 apply to different types of equipment. For example, commercial equipment is divided into 12
 13 different "types" according to the commercial index factors provided by the Board. Each "type"
 14 is associated with its own set of factors. Similarly, industrial machinery and equipment is
 15 divided into six groups. Only after the business and equipment type is identified can the
 16 appropriate index factor be identified and applied.

17 Finally, it must be noted that the index factors in AH 581 apply to *typical* groups of equipment
 18 within the identified classifications and therefore are not always appropriate to the property being
 19 appraised. The index factors in AH 581 are intended to be used to provide a time-efficient
 20 method of making reasonable estimates of replacement costs for typical properties; they are a
 21 tool for estimating fair market value. When reliable evidence of current replacement costs (e.g.,
 22 catalogs or current selling prices of comparable new equipment) is available, it may be more
 23 appropriate to process the cost approach using the market-indicated costs rather than the trended
 24 historical costs.

25 **Percent Good Factors**

26 In a mass appraisal program, percent good tables are frequently used in estimating depreciation.
 27 Percent good, as a percentage, is the complement of depreciation. For example, if total
 28 depreciation is 20 percent, then percent good is 80 percent. The percent good concept is used in
 29 the appraisal process for two reasons: (1) it focuses the appraisal on the benefits remaining or the
 30 economic life remaining in the property rather than the benefits used; and (2) it saves one
 31 arithmetical operation when estimating depreciation.

32 **Derivation of Percent Good Factors**

33 A thorough discussion of the theory and mathematical calculations behind the
 34 development of percent good factors is not within the realm of this manual; the subject is
 35 covered in-depth in AH 582, *The Explanation of the Derivation of Equipment Percent*

¹¹⁵ U.S. Department of Labor Bureau of Labor Statistics, *BLS Handbook of Methods*, 132.

¹¹⁶ American Society of Appraisers, *Appraising Machinery and Equipment*, 44.

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1 *Good Factors.* Nevertheless, in order to apply and select appropriate factors within the
2 tables using economic life estimates, a brief overview of the discussion is needed here.

3 Percent good factors and tables are developed based on the present worth of future net
4 operating income (constant terminal income approach) of the existing property versus the
5 present worth of future net operating income for an identical new property, with a small
6 "income adjustment factor" reduction for older property. The remaining and total
7 economic life estimates are based on survivor curves, which express the relationship
8 between total life expectancy and probable remaining life expectancy of property items in
9 all stages of their lives. A survivor curve or table represents the life expectancy at any
10 age for that particular population. The survivor curves used by the Board, based on
11 statistical data regarding a series of equipment mortality studies, were developed by Iowa
12 State University. The R-3 curve is used for the machinery equipment table in AH 581
13 because, historically, mortality patterns of machinery and equipment most commonly fit
14 this curve.

15 To use percent good tables, accurate estimates of *average service life* or *remaining economic life*
16 must be made. Therefore, the following terms must be defined:

17 *Economic life:* the anticipated service life for a unit when it is new.

18 *Remaining economic life (REL):* the expected remaining life of the property on the
19 appraisal date.

20 Economic life can be determined by an appraiser based on historical usage of property, useful life
21 expectancy as determined by the taxpayer, or other information as available. Obviously in mass
22 appraisal situations, determining economic life for each piece of equipment is not practical, and is
23 not estimated on an individual basis unless necessary. It may occur in practice, however, when
24 the taxpayer files an appeal, when an audit is conducted, or when equipment is self-built.

25 The estimated economic life, is then used to estimate average service life of the item. In general,
26 *average service life* is utilized in the percent good tables. When an item is new, *average service*
27 *life* is the average economic life of comparable equipment. When an item is not new (used), the
28 item's *remaining economic life* is usually *greater* than the original average service life minus age.
29 This occurs because in any group of equipment, some items "die" prematurely, so the life of the
30 remaining items would generally exceed the average service life.

31 Any percent good table or depreciation schedule, including those published by the Board, can be
32 used only as a guide in the estimation of value. They may reflect more or less depreciation than
33 the actual market indicates. If equipment has experienced abnormal, excessive or even less-than-
34 typical depreciation, the percent good factors may not be reliable indicators. In this case, a
35 percent good factor could be used in combination with another method of depreciation
36 calculation, or it may be necessary to use another approach to value altogether. This is also true
37 if the equipment is unique, if limited cost information is available, or if age or expected life
38 cannot be accurately determined. Therefore, whenever possible, an appraiser should verify

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replacement cost new less depreciation by other approaches before accepting a mass-appraisal indicator such as the indicator developed from an AH 581 table as the best indicator.

Other Methods of Calculating Depreciation and Value

Assessors tend to utilize equipment index factors and percent good factors published by the Board for the majority of appraisals concerning personal property. However, in certain situations, different methods of estimating depreciation and value may be appropriate. In other cases, alternative factors and tables will provide more accurate estimates of value. As discussed above, this may include equipment which has experienced unusual depreciation, unique equipment, or property having limited cost information available.

Following are other methods of calculating depreciation, commonly used in the appraisal of personal property, although this is by no means a complete listing. They are methods that may be helpful in determining the market value of equipment when the application of factors from AH 581, *Equipment Index and Percent Good Factors*, do not reflect market value of the property being appraised. Sound appraisal judgment is required to determine which method(s) of calculation to use based on the information available.

Straight-Line or Age-Life Method

Under this approach, depreciation is estimated by dividing the actual or effective age of the property by the estimated economic life. The straight-line or age-life method is based on the relationship between physical age and estimated economic life. Physical life, or age, is the time the equipment has existed. Economic life of a property represents the period of time during which the property has value.

Although straight-line depreciation may have little or no bearing on market value, effective age should be recognized whenever data reasonably indicates that effective age is different than actual age. *Effective age* is the "age indicated by the condition and utility of a structure,"¹¹⁷ (or property). Because there may be a large variation in the condition of property having the same age, the effective age (as opposed to the actual age) is the best indicator of the market's perception of age.

This approach does not reflect the relationship between the present worth of the future earnings of the property versus the present worth of future earnings of a new replacement property. It ignores the principle that money has a time value (income to be earned in the near future has a greater value than the same amount of income to be earned in the distant future); thus it tends to understate the economic value of older property that is producing a current income comparable the current income that would be produced by a new replacement. Conversely, this method does not reflect additional depreciation that should be recognized if the existing property income is *less* than the income that would be earned by a new replacement.

¹¹⁷ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "effective age".

DRAFT**Observed Condition Method**

Using the observed condition method, the appraiser estimates depreciation by estimating the cost to cure depreciation which is in fact curable, items of physical deterioration and functional obsolescence. This requires an appraiser to have specific knowledge of the equipment being appraised and of the market for that equipment. This method cannot measure incurable functional obsolescence or economic obsolescence.

Production Output or Service Hours Method

The Production Output Method is based on the assumption that an asset is acquired for production, and it depreciates in relation to units produced. To use this method of calculation, an estimate of total ultimate output is required. (The estimate can be in production units or service hours.) Full economic cost divided by the ultimate output gives the depreciation charge for each unit of output. Like straight-line method, this method ignores the economic value of future earnings and thus will understate the value of a property if net operating income is comparable to a new replacement property and will overstate the value to the extent net operating income is less than a new replacement property.

Utilization Adjustment

A utilization adjustment to a Replacement Cost Less Normal Depreciation (RCLND) estimate may be appropriate when equipment is significantly underutilized, that is, it may be appropriate when property is not used at design or expected capacity. This condition of underutilization may exist because of functional obsolescence, external obsolescence, or a combination of both, and usually originates with external forces. These external forces diminish the demand for use of the property which results in the existence of property with capacity that would not be replaced. The condition may also occur due to errors in initial planning. The adjustment is analogous to an abnormally-high vacancy factor used to calculate net operating income for use in the capitalized income approach to value.

Utilization adjustments may be made when there is significant permanent excess capacity that is beyond the control of a prudent operator. Generally, the amount of obsolescence is a function of the difference between the replacement cost new of the existing property versus the replacement cost new of a property with a capacity that is adequate for the foreseen requirements. However, operation at below design capacity will not always translate to an equivalent percentage amount of obsolescence (i.e., operating at 75 percent of design capacity may only equate to a 10 percent increase in obsolescence). An explanation of this seeming incongruity is demonstrated in pipeline valuation. Much of the cost of constructing a pipeline is the same regardless of the design capacity because installation charges do not vary proportionally to the diameter of the pipe. Cost is much the same regardless of the design capacity. Consequently, a pipeline with a physical utilization of 90 percent of design capacity is considered to be at 100 percent of economic utilization because the replacement cost new of a pipeline with the lower design capacity would cost essentially the same as the replacement cost new of the existing capacity.

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To make a utilization adjustment when appropriate, for significant permanent excess capacity which affects value, information should be gathered and an appropriate means for estimating the adjustment should be determined. The Board's Valuation Division, for example, has a formula for reducing the RCLND of pipelines that are clearly oversized for the foreseeable future. The calculation begins with knowledge of the level of the foreseeable physical utilization of a pipeline segment (the "load" factor) which is expressed as a percentage amount. This "load" factor is converted to a "utility" factor which is also expressed as a percentage amount; this calculation is non-linear. The utility factor represents the ratio of needed capacity to design capacity and it is applied to an RCLND estimate to reach an estimate of Replacement Cost Less Depreciation (RCLD).

As mentioned above, this type of adjustment is not appropriate for all or even most types of properties (or equipment). Even when a property operates significantly below design capacity, there may be no under-utilization and a utilization adjustment would not be appropriate. However, when evidence reasonably demonstrates that replacement property would have a lower capacity, a utilization adjustment may be appropriate. Sound appraisal judgment is necessary to determine if such an adjustment is appropriate. A study of the facts pertaining to that particular property is necessary to determine how to arrive at any appropriate adjustment.

Following are some suggested items to consider if there is a question of excess capacity.

- Is full capacity ever needed or expected?
- What is the *normal* utilization for similar equipment (what utilization do purchasers of new similar equipment anticipate)?
- What is the cause of the excess capacity? (External obsolescence is a valid reason; normal seasonal or even daily variations do not constitute excess capacity.)
- Is the problem industry-wide or is it the individual owner? (An industry-wide excess capacity is indicative of external obsolescence; individual excess capacity may be a business enterprise problem that should not be reflected in the value of the property.)
- Is there evidence that the equipment would be replaced with substitute equipment of lower capacity?
- What is the replacement price differential between existing and replacement equipment?

Sampling

Indexes published in AH 581 are based on government price indexes derived by sampling. Similarly, the computer valuation tables computed and published by the Board via Letter(s) to the Assessor (LTA's) are based on sampling. When necessary and resources are available, the assessor may conduct similar such studies to derive their own indexes.

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Where the equipment index and percent good factors provided by the Board, and other approaches to value and methods of estimating depreciation, are not good indicators of value, an assessor may wish to use some type of sampling methodology to develop their own factors. This may be a viable method of estimating depreciation. To use sampling, assessors and auditors must develop and use recognized methods that will be accepted with confidence by the Board, taxpayers, and their agents. In developing a sample plan, technique, and program, an interested reader should consult a textbook on statistics for information on the theory and application of sampling. For an example, see the Board's *Sales and Use Tax Audit Manual*, Chapter 13: *Statistical Sampling*.

Limitations of the Cost Approach

An appraiser cannot assume that the cost approach, or any approach, automatically provides the best indicator of value. When available or possible, it is best to compare estimated value to actual market value of similar property to verify accuracy of results.

The cost approach, like other approaches to value, is not valid unless it is made as of a specific date. The fluctuating purchasing power of money, together with changes in the efficiency of labor and changing techniques of production, and other economic factors cause costs and depreciation to vary over time. It is therefore essential to specify that costs are as of a certain date (i.e., the appraisal date) in order for the principle of substitution to be meaningful. The more current the costs, the newer the property, the more reliable and valid the cost approach to value will be.

The cost approach is also limited by the accuracy of the estimates used. If the cost and depreciation estimates are skewed or otherwise unrepresentative of the property, the resulting value will not be an appropriate representation of the property's market value.

Summary of the Cost Approach: Example

The following example illustrates the valuation of a piece of equipment using the cost approach method of valuation. Keep in mind, however, when the cost approach is applied to personal property it is normally applied to groups of equipment (rather than on a piece by piece basis) and such detailed information may not be available. The example illustrates an application of the approach and is used to summarize the discussion in the text. It is not controlling in all situations.

DRAFT**Example 4.3: Use of the Cost Approach**

Company C acquired a bookbinding machine in 1995. Details of the acquisition are as follows:

- Invoice cost (including sales tax) \$40,000 •
- A 1% discount was allowed because payment was made in cash within 30 days.
- Company C's Transportation cost of \$1,200 was paid to deliver the machine to the factory
- Cost of installation was \$2,430. This included labor, materials, including a raised flooring to accommodate the new machine.
- The chief engineer spent 2/3 of her time during July on trial runs of the new machine. Her monthly salary is \$9,000 per month.
- An allowance of \$5,500 was granted by the supplier because the machine proved to be of less than standard performance.

What is the machine's assessable value on the 1998 lien date?

A. Computation of Full Economic Cost:

Invoice Cost	\$40,000
less: Discount	(400)
Rebate/Allowance	(5,500)
add: Transportation Cost	1,200
Installation Costs	2,430
Machinery Validation Cost (\$9,000 salary x 2/3)	<u>6,000</u>
Full Economic Cost	<u>\$ 43,730</u>

B. Computation of Value

Using the Board's index factors and percent good factors, the equipment was found to be included in Group 5 - Manufacturing Equipment with an estimated economic life of 15 years. From the tables, the index factor is 1.04 and the percent good factor is .85. Using this information, the full cash value (assessable value) is estimated:

\$43,730 x 1.04 x .85 =	<u>\$38,657</u>
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DRAFT**COMPARATIVE SALES APPROACH**

The comparative sales approach may be defined as any approach that uses direct evidence of the market's opinion of value of a property. It is based upon the principle of substitution, that is, the fair market value of an item is closely and directly related to sales price (under the conditions of fair market value) of comparable, competitive properties. Thus, this method presumes that the value of a property will approximate the selling prices, listings, offers, the opinions of owners and appraisers, and appraisals of competitive substitutes. Ideally, however, value is estimated based not only an opinion of value (such as list price), but one that is supported by the outlay of money - in other words, actual purchases of comparable properties.

Sale prices of comparable properties provide an indication of what the market is willing to pay for that type of property at that time. For personal property, value guides and price schedules which reflect the going market price for comparable equipment and which estimate the current value of specific types of equipment are used as the basis for determining market value of similar equipment. Adjustments should be made when the condition of the subject property is above or below average. Additional elements of value seldom reflected in sales comparison value guides are sales tax and freight. Sales tax and freight must be added to the sales price of equipment to arrive at full cash value for property tax purposes.¹¹⁸

The comparative sales approach is limited in its application to personal property, and is used less often than is the cost approach to value, because (1) most types of personal property are sold infrequently (limited sales data is available), (2) sales data, when available, is generally limited by comparability, and (3) in many cases, personal property is not sold without affecting other property (whether real or personal property). This approach is, however, applicable to personal property that is frequently exchanged in the market when its exchange does not affect other items; usually this includes agricultural and construction equipment, boats, and airplanes.

Sources of Information

The appraiser may utilize valuation guides in making the appraisal estimate when sufficient information regarding the make, model, etc., of the equipment is reported on the property statement, or otherwise available (such as through audit), and when such guides are available.

When using the comparative sales approach to value real property, numerous sources of data are available. When valuing personal property, this is not always the case. The following table includes a short list of valuation guides available for use in valuing personal property. Other available publications, which may be helpful, are listed in *Appraising Machinery and Equipment*.¹¹⁹

¹¹⁸ *Xerox Corp. v Orange County* (1977) 66 Cal.App.3d 746.

¹¹⁹ American Society of Appraisers, *Appraising Machinery and Equipment*, Pages 53-57.

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Table 4C: Sources of Information		
Equipment Type	Name of Publication	Phone #
Agricultural Equipment	<i>National Farm Tractor and Implement Blue Book</i>	312-726-2802
Agricultural Equipment	<i>Official Guide - Tractors and Farm Equipment</i>	916-678-8859
Construction Equipment	<i>Green Guide for Construction Equipment</i>	800-669-3282
Vessels	<i>BUC Used Boat Price Guide</i>	800-327-6929
Vessels	<i>N.A.D.A. Appraisal Guides</i>	800-966-6262
Vessels	<i>National Boat Book Official Used Marine Valuation</i>	312-726-2803
Aircraft	<i>Aircraft Bluebook Price Digest</i>	800-654-6776
Aircraft	<i>Vref Aircraft Value Reference</i>	800-773-8733

1
2 When reliable comparables are available, whether from sales in the market, costs guides, or other,
3 the comparative sales approach may be preferable to other value approaches. Following is an
4 example where such sales are available and value is determined using the Comparative Sales
5 Approach as discussed in this section.

Example 4.4: Use of the Comparative Sales Approach

John Doe purchased a new 1990 Bayliner boat with 110 HP mercury engine and trailer in 1990 for \$15,000. On the 1997 lien date, this boat was located in the county and was assessable.

The following information was available to and gathered by the appraiser:

- The taxpayer is planning to sell the boat to his brother next month for \$1,000 because he is moving out of state.
- A similar boat (with trailer) was seen advertised in the local newspaper for \$9,000.
- Research in two separate value guides found a value range from \$6,500 to \$8,000 for this particular boat in average condition.
- An inspection of the boat and a conversation with the taxpayer found the boat to be in good, average condition for its age.

The taxpayer argues that the boat's value is \$1,000. **Using the comparative sales approach to value, what is the estimated taxable value of this vessel?**

The estimated taxable value of the boat is between \$6,500 - \$8,000 using two separate used boat value guides. The taxpayer's estimate of value, \$1000, does not represent of market because it is not an arm's length transaction, has not occurred under normal circumstances, and is not a "sale" (the sale has not occurred yet). The advertisement in the local paper supports this value range. The \$9,000 selling price less the value of the trailer plus applicable sales tax falls within the same range estimated using the value guides. The appraiser in this case estimates the value at **\$7,000**.

DRAFT**1 INCOME APPROACH**

2 The income approach to value includes any method of converting an anticipated income stream
3 into a present value estimate. This approach can be considered as an approach to value when the
4 subject property meets three assumptions:

5 (1) Value is a function of income

6 (i.e., the property is purchased for the income it will produce);

7 (2) Value depends upon the quality and quantity of the income stream

8 (i.e., the investor demands a return of and on his/her investment in the property);

9 (3) Future income is less valuable than present income

10 (i.e., the value of the property is the sum of the present worth of its anticipated
11 future net benefits).

12 When any of these do not correspond to the reality of the property, the income approach to value
13 should not be given great weight as an indicator of the property's current market value.

14 In relation to personal property, this approach has limited application. It can be applied to leased
15 equipment or other personal property appraisal units that independently produce income because
16 expected rental income can be converted to a present value estimate. However, it is normally not
17 applicable to most types of personal property. Personal property, in general, is not purchased to
18 independently produce income. It is therefore impossible to assign or estimate an expected
19 income to that individual property.

20 A general discussion and explanation of the income approach to value is included in AH 501,
21 *Basic Appraisal*, and the income approach chapter of AH 502, *Advanced Appraisal*. These
22 sections will not be repeated here. Below is a short discussion of how, and when, the approach
23 can be applied to personal property. When using this technique, refer to the above mentioned
24 sections for additional in-depth discussion of the income approach.

25 Valuation Using the Income Approach

26 The income approach to value can be used to appraise personal property in the same way it can be
27 applied to circumstances involving the valuation of land and buildings. However, there are
28 several aspects of appraising personal property that may differ from those encountered in the
29 valuation of real property. These include:

- 30 • It should be verified that the income is truly generated by the property. In many cases, the
31 "rental" or "lease" income is significantly influenced by selling skills, business activity,
32 personal services, sales or services directly related to the rented property (the rental amount
33 could be artificially high or artificially low), or other non-property factors. In such cases
34 the income approach is unlikely to measure the value of the personal property.

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- 1 • Since personal property usually has a much shorter economic life than real property, an
- 2 error in the estimate of remaining economic life will have a much greater impact than it will
- 3 for real property.
- 4 • It is more difficult to find direct market evidence for capitalization rates for personal
- 5 property as compared to real property.

6 Despite the problems, where income(s), capitalization rates, and economic life estimates are

7 available and reliable, the income approach is equally valid for personal property as it is for real

8 property.

9 Both direct capitalization methods and yield capitalization methods may be utilized to appraise

10 personal property. When valuing personal property, yield capitalization is the preferred method

11 because information is more readily available and the life span of the property is usually short.¹²⁰

12 In addition, the income stream produced by personal property usually involves a reversion income

13 from the selling of the scrapped item at the end of the economic life.

14 The components that make up the value of personal property are the costs of manufacturing the

15 item, transportation of the item, installation of the item, and profit markups. Additionally, a sales

16 tax or a use tax component must be added. The components of the value of personal property

17 may be borne by either the lessor or the lessee. Payment of expenses by the lessee do not

18 diminish the value of the personal property. The terms of the lease agreement or rental contract

19 should be carefully analyzed to insure that all costs are included in the valuation process. When

20 the costs of transportation or installation are paid by the lessee, the economic income may have

21 to be adjusted to include a charge for these expenditures in the valuation process, or the costs

22 may be added as a lump sum to the capitalized earning ability of the income stream. However it

23 is done, all property expenditures must have been properly identified and included in the value of

24 the (leased) equipment.

25 Maintenance of the property, on the other hand, may make up part of the lease cost but is not a

26 component of value. For instance, if the lessor is charging the lessee for maintenance under the

27 lease contract, the auditor appraiser must make an estimate of service time, and then relate this to

28 prevailing rates.¹²¹

¹²⁰ Direct capitalization is not discussed in this section of the handbook. See AH 501 and AH 502 for information regarding direct capitalization and more information regarding the income approach in general.

¹²¹ Service time, rates, costs, and maintenance expenses estimates and percentages may be obtained from various sources in the marketplace (for instance, the lessor may be able to supply the actual service time for the preceding year), and this could serve as a guide when reconstructing the operating statement.

DRAFT**Example 4.5: Adjusting Income For Maintenance Charges**

A machine requires 3 hours of service each month at a rate of \$95 per hour:

a monthly cost of \$285 ($\$95 \times 3 = \285).

If the monthly rental is \$1500:

then, the maintenance is 19% of gross income ($\$285 / \$1500 = .19$, or 19%).

Gross annual income is then \$18,000 ($\$1,500 \times 12 = \$18,000$), annual expenses are \$3420 ($\$285 \times 12 = \$3,420$), and the net annual income is \$14,580 ($\$18,000 - \$3,420 = \$14,580$).

Processing the Income Stream

The steps for processing the rental income stream for personal property are the same steps that are used for processing real property income. The steps are as follows:

Potential Gross Income (PGI)
(less) <u>Vacancy and Collection Losses (V & C)</u>
Effective Gross Income (EGI)
(less) <u>Operating Expenses</u>
Net Income Before Recapture and Property Taxes (NIBR&T)
(less) <u>Property Taxes</u>
Net Income Before Recapture (NIBR)
(less) <u>Allowance for Recapture</u>
Net Income (Yield Income)

As with real property, the anticipated income stream of personal property is processed when deriving income multipliers and rates. In the valuation of personal property, the income stream cannot be processed below NIBR&T.¹²²

Vacancy (Idle Time) and Collection Losses

Personal property that is held for lease or sale by a retailer or wholesaler on the lien date may be exempt from taxation. Because these items are exempt for the entire year, it can be argued that it is improper to allow for vacancy (idle time) and collection losses. However, it is also reasonable

¹²² When calculating NIBR&T for business property, status, category and trade level of the property are important factors to consider.

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to take the position that an item may be out on lease on the lien date (and therefore taxable) but returned to the retailer or wholesaler prior to the expiration of the lease period. Consequently, the retailer or wholesaler may very well suffer a loss of income because of vacancy (idle time) or collection loss. An allowance made for vacancy (idle time) and collection loss should be based on the actions of the market place.

Expenses

As with real property, all lessor-borne expenses that are necessary to maintain the income stream may be deducted as an operating expense. If the expenses are paid for by the lessee, they are not deductible from the income stream. Maintenance expense is a good example. Maintenance is often a major expense but, if the lessee pays the maintenance charges, the lessor will generally charge a lesser rent and the expenses are not allowed. If the lessor is responsible for maintenance, the rents will reflect this expense. An adjustment will be necessary similar to that shown in Example 4.5.

Particular care must be given to analyzing expenses. They may have been paid by either the lessor or the lessee, and therefore included on either or both books. The lessor's books may show an expense for maintenance. If the lessee has purchased a maintenance contract from the lessor, the price of the contract must be added to the rental fees before processing the income stream. If it is not, then the expenses for maintaining the item are not deducted as an expense.

Valuation Methodology

When yield capitalization methods are used to value an item of personal property, the present worth of each year's income and the reversion are computed as separate income streams. The present value is the sum of the present worth of each income.

Personal property is often valued using a property reversion income method. The rental income is capitalized using direct capitalization techniques. This income is usually constant terminal income and is often called an *annuity*. The reversion income is capitalized using the same procedure that is used in yield capitalization. The present value is the sum of the indicated values. The formula for the valuation of a level annuity income stream and the reversion income is as follows:

Note: PR is the periodic repayment factor, based on an appropriate yield rate and the estimated life of the personal property. ETR is the effective tax rate applicable to the enrolled taxable value. PW\$1 is the present worth of \$1, based on the yield rate plus the effective tax rate and the estimated life of the item.

$$\frac{\text{NIBR\&T}}{\text{PR} + \text{ETR}} = \text{VALUE OF THE ANNUITY}$$

$$\text{REVERSION} \times \text{PW \$1} = \text{REVERSION VALUE}$$

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The reversion income is usually the salvage value of the personal property. It is the *net* amount of money the owner expects to obtain when disposing of the property, not necessarily the price stated in the original contract (estimated residual value). This stated price, the "buy-out cost", is probably not an accurate indicator of value when the property is purchased at the end of the lease (i.e., a \$1 buy-out cost does not represent residual value). The reversion is usually positive, although it can be a negative amount. Occasionally, it is zero or a nominal amount and has no bearing on market value at the end of the lease.

The total value of the personal property is as follows

PV OF THE ANNUITY

+ PV OF THE REVERSION

TOTAL VALUE

DRAFT**Example 4.6: Using the Income Approach to Value Personal Property :**

A manufacturer leases reproduction machines to various businesses within your county. The number of machines on lease in the county as of the lien date is 50. The machines are leased for a one-year term. The average annual gross income of each machine on lease is \$2,700 per machine. The rental income includes a component for sales tax.

You have determined that the machines have an average total life of seven years; however, the average remaining economic life of the machines on lease, as of the lien date, is estimated at four years. Property taxes are one percent of the full cash value. Yield rates derived from sales indicate a 13.5 percent return. The return on the investment is based on a constant terminal income stream premise. The periodic repayment factor (PR) is 0.33969.

Other pertinent information:

- The salvage value per machine is \$500.
- Typical annual expenses of a machine on lease is \$500 for maintenance and \$200 for insurance.

What is the estimated taxable value of the machines?		
A. VALUATION OF THE RENTAL INCOME	Per Machine	Total (50 Machines)
Market Potential Gross Income	\$2,700	\$135,000
less: Vacancy & Collection Loss	0	0
Effective Gross Income	\$2,700	\$135,000
Expenses: (Maintenance \$500 + Insurance \$ 200)	(700)	(35,000)
Net Income Before Recapture & Taxes (NIBR&T)	<u>\$2,000</u>	<u>\$ 100,000</u>
NIBR&T / (0.33969 PR + 0.01 ETR)	\$5,719	\$285,965
B. VALUATION OF THE SALVAGE VALUE		
Salvage Price	\$500	\$25,000
PW \$1 (13.5% Yield + 1% ETR) ¹²³	0.581806	0.581806
Present Value Of Salvage Income	\$291	\$14,545
C. TOTAL PROPERTY VALUE		
Present Value of Rental Income	\$5,719	\$285,950
Present Value of Salvage Income	<u>291</u>	<u>14,545</u>
TOTAL VALUE	<u>\$6,010</u>	<u>\$300,495</u>

¹²³ Present worth of \$1 at 14%, factor from compound interest table.

DRAFT**Summary of the Income Approach**

The example above helps to illustrate how the income approach to value can be used in the appraisal of personal property. In practice, each situation is different and on an assessment of leased property must take this into consideration.

In relation to personal property, this approach has limited application. It can be applied to leased equipment or other personal property appraisal units that independently produce income because it converts expected rental income to a present value estimate, but it is normally not applicable to most types of personal property. Personal property, in general, is not purchased to independently produce income. It is usually impossible to assign or estimate an expected income to that individual property.

RECONCILIATION AND VALUE CONCLUSION

The final step in the appraisal process is to reconcile value indicators from the separate approaches utilized into a final estimate of value, when more than one approach to value is applied. Resolving the differences among the value indicators is called *reconciliation*. The result of the reconciliation is the final value estimate.

In the reconciliation process, consideration should be given to any factors influencing value that are either not reflected or only partially reflected in the indicators. The greatest weight should be given to that approach or combination of approaches that best measures the type of benefits the subject property yields. The reconciliation step should involve an analysis of: (1) the relative appropriateness of the approaches applied; (2) the accuracy of the data collected and calculations made in each approach; (3) the quantity of data available for each approach; and (4) the consistency in the manner in which the approaches to value were applied.

For example, a cost estimate should be reviewed for the realism of the depreciation estimate and whether it is supported by market data. If the sales comparison approach was used, a check should be made to determine whether the indicator relies heavily upon only one sale. In reviewing the income approach, the appraiser should reexamine the estimates of economic rent, economic life, expenses, and capitalization rate. Alternative estimates should be considered. Additionally, the appraiser should consider whether, and avoid, estimates that are consistently optimistic or pessimistic.

Although containing an element of judgment, the analysis of value indicators should be based upon indicators derived from objective data, plus general overall value influences (economic, physical, political, and social factors). If a value indicator were perfect, it would already reflect these value influences. However, in actual practice, any value indicator is usually far from perfect. As indicated above, if the appraiser has adequate and reliable data, the greatest reliance should be placed on that indicator which best measures the type of benefits the subject property is expected to yield.

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CHAPTER 5: ASSESSMENT OF IMPROVEMENTS RELATED TO BUSINESS PROPERTY

Improvements related to business property include improvements reported on Schedule B of the Business Property Statement and other improvements owned by or made for a business. Many variables exist regarding the assessment of these improvements. Factors required to make a valid assessment—especially property classification, identification of assessee, and valuation—may be difficult to determine. Depending on the data source, the assessment can be processed by either the real property appraiser, the auditor appraiser or both, on either the secured or unsecured roll, creating a situation that may result in duplicate or escape assessments. Assessment of improvements related to business property is, therefore, an important topic for discussion within this portion of the Assessors' Handbook and in AH 502, *Advanced Appraisal*.

The focus on this chapter is the assessment of improvements related to business property. The chapter is divided into four main sections: definitions of relevant terms, classification, appraisal, determination of assessee, and suggested procedures. The discussion is directed to both real property appraisers and auditor appraisers.

DEFINITIONS OF RELEVANT TERMS

The purpose of this section is to define and describe the following relevant terms: improvements, building improvements, landlord improvements, leasehold (or tenant) improvements, structure items, and fixtures as used in the context of property tax .

IMPROVEMENTS

As defined by the Legislature in section 105, *improvements* include:

(a) All buildings, structures, fixtures, and fences erected on or affixed to the land.

(b) All fruit, nut bearing, or ornamental trees and vines, not of natural growth, and not exempt from taxation, except date palms under eight years of age.

Improvements within this statutory definition are reported, classified and subclassified on the Business Property Statement, Schedule B.¹²⁴ Examples of such improvements are provided in Rule 124(b).

BUILDING IMPROVEMENTS

Building improvements are all improvements to a structure. They may include improvements made by the landlord and improvements made by or for the tenant (*landlord improvements* and *leasehold/tenant improvements*). They can be sub-classified as structure items and fixtures.

¹²⁴ No classification between structure and fixture is required for State assessed leasehold improvements.

DRAFT**1 LANDLORD IMPROVEMENTS**

2 For purposes of this discussion, improvements made by the real property owner are referred to as
 3 *landlord improvements*. This term includes improvements paid for by the landlord whether they
 4 benefit the landlord or the tenant. Landlord improvements can be subclassified as structure items
 5 and fixtures, as discussed below.

6 LEASEHOLD (OR TENANT) IMPROVEMENTS

7 For property tax purposes, the terms *leasehold improvement* and *tenant improvement* are used
 8 synonymously as all "improvements or additions to leased property that have been made by the
 9 lessee."¹²⁵ These may also include structure items as well as fixtures paid for by the lessee.

10 For example, two tenants move into separate units.

- 11 • Tenant A moves into a shell and makes basic improvements (e.g., a drop ceiling, floor
 12 finish, floor to ceiling partitions for an office) to finish the interior of the structure.
- 13 • Tenant B moves into a space ready for occupancy and only makes improvements designed
 14 for a specific trade business, or profession (e.g., shelving attached to a wall or dressing
 15 rooms in the case of retail apparel sales).

16 As the definitions below will indicate, Tenant A has made improvements classified as structure
 17 items. Tenant B has made improvements classified as fixtures. However, in both cases, the
 18 improvements made by the tenants are leasehold (or tenant) improvements.

19 STRUCTURE ITEMS

20 A *structure* is "an edifice or building; an improvement."¹²⁶ Structure items are integral parts of
 21 the structure by nature. The Business Property Statement further describes structure items:

22 An improvement will be classified as a structure when its primary use or purpose is
 23 for housing or accommodation of personnel, personalty, or fixtures and has no
 24 direct application to the process or function of the industry, trade, or profession.

25 Structure items are reported on the property statement on Schedule B, column 1, *Structure Items*.
 26 A listing of items commonly reported and classified as structure items can be found in appendix
 27 XX.

¹²⁵ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "leasehold improvement" p. 204.

¹²⁶ Appraisal Institute, *The Dictionary of Real Estate Appraisal*, s.v. "structure." p. 353.

DRAFT**1 FIXTURES**

2 Subdivision (a) of Rule 122.5 defines *fixtures* and sets forth three tests for determining what
3 constitutes a fixture for property tax purposes:¹²⁷

4 Intent (most important)

5 (1) A fixture is an item of tangible property, the nature of which was originally
6 personalty, but which is classified as realty for property tax purposes because it is
7 physically or constructively annexed to realty with the intent that it remain annexed
8 indefinitely.

9 Manner of annexation

10 (2) The manner of annexation, the adaptability of the item to the purpose for
11 which the realty is used, and the intent with which the annexation is made are
12 important elements in deciding whether an item has become a fixture or remains
13 personal property. Proper classification, as a fixture or as personal property,
14 results from a determination made by applying the criteria of this rule to the facts
15 in each case.

16 Adaptability:

17 (3) The phrase "annexed indefinitely" means the item is intended to remain
18 annexed until worn out, until superseded by a more suitable replacement, or until
19 the purpose to which the realty is devoted has been accomplished or materially
20 altered.

21 Fixtures are reported on the Business Property Statement, Schedule B, column 2, *Fixtures Only*.
22 A listing of items commonly reported and classified as fixtures can be found in appendix XX. It is
23 important to note, however, that these items are fixtures only when they are **not** an integral part
24 of the building, but their use or purpose directly applies to or augments the process or function of
25 a specific trade, industry, or profession.¹²⁸

26 Types of Fixtures**27 Trade Fixtures**

28 In the context of property tax, a *trade fixture* is merely a type of fixture which is "trade-related".
29 All fixtures, including trade fixtures, have received the same treatment by the courts. In the
30 interest of uniformity of taxation, neither the statutes nor the courts base the classification of
31 fixtures on whether they are "trade-related". As expressed by the court in *Trabue Pittman Corp.*
32 v. *County of Los Angeles* (1946) 29 Cal.2d 385,

¹²⁷ Discussion of the three tests for determining classification as fixture (physical annexation, constructive annexation, and intent) is included in Chapter 2: *Classification*.

¹²⁸ Rule 463(c).

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To classify trade fixtures as real property is not to obliterate the distinction between fixtures and trade fixtures for all purposes, nor to introduce an innovation into the law of trade fixtures. It is well settled that for purposes of taxation the definitions of real property in the revenue and taxation laws of the state control whether they conform to definitions used for other purposes or not. ...Section 104 of the Revenue and Taxation Code declares that real estate shall include "improvements", and section 105 defines improvements as "fixtures". No exception is made in the case of trade fixtures. According to Burby, a trade fixture is merely a particular type of fixture, one for which the law makes a special provision permitting its removal under certain circumstances by a lessee from the lessor's real property to which it has been annexed. (See Burby Hornbook of the Law of Real Property (1943) p.28).

In a subsequent case deciding similar issues, the court held:

It follows [from *Trabue Pittman* above] that the applicable statutes do not permit the division of trade fixtures into classes or distinctions contended for by defendants, and on the contrary require all fixtures or trade fixtures to be taxed as improvements.¹²⁹

Additionally, trade fixture, in section 469 and fixture in Rule 192(a) are used synonymously in the determination of a mandatory audit. Thus, trade fixtures are merely a particular type of fixture and must be evaluated under the three-part test in Rule 122.5.

Fixed Machinery and Equipment

Fixed machinery and equipment (FME) is another type of fixture. FME is equipment which is physically or constructively annexed and intended to remain indefinitely with the realty. As discussed in Chapter 2 of this manual, Rule 122.5(c) sets forth the standard for constructive annexation and some examples are provided in subdivision (e). The concept of constructive annexation of equipment has long been recognized by the courts.

In addressing the question of annexation, we initially observe that the common law test of technical affixation of the article to the realty is no longer an absolute prerequisite to "fixture status." On the contrary, the modern trend of case law underlines that fixtures include articles such as heavy machinery whose permanent annexation is not manifested by the use of bolts, screws, and the like, but which are of such weight that the mere retention in place of gravity is sufficient to give them the character of permanency and therefore affixation to the realty.¹³⁰

A taxpayer may erroneously report FME as personal property (i.e., machinery and equipment) on Schedule A of the Business Property Statement. The taxpayer may report such property as machinery and equipment because of its use/function as machinery or equipment. However, if

¹²⁹ *Simms v. County of Los Angeles* (1950) 35 Cal.2d 303,304.

¹³⁰ *P.M. Moller, Inc. v. Wilson*, 8 Cal..2d 31.

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the property's weight or method of attachment and the taxpayer's intent is that the property remain annexed indefinitely, then based on Rule 122.5, such equipment is actually FME, that is, a fixture. (Often, the incorrect classification is discovered by physical inspection.)

CLASSIFICATION**CLASSIFICATION ON THE PROPERTY STATEMENT**

Schedule B (including supplemental schedule) of the Business Property Statement requests information regarding building improvements (landlord and leasehold improvements) in relation to a specific property or business. This schedule provides valuable information and may be used by both auditor appraisers and real property appraisers. Items reported in column 1 and column 2 are structure items and fixtures, respectively, as defined earlier. Items reported in Column 3, *Land Improvements*, include such things as blacktop, curbs, and fences; and items reported in column 4, *Land and Land Development*, include such things as fill and grading.

WHY CLASSIFICATION IS IMPORTANT

The statutes require that improvement value be shown separately from land value and personal property value on the roll. However, there is no requirement that structure value and fixtures be shown separately.¹³¹ It is necessary for the appraiser to make the distinction between structure items and fixtures prior to enrollment, because classification may affect the valuation of property.

As the courts have stated, "...uniformity of taxation cannot be attained unless a uniform classification of real and personal property is established."¹³² It is important to properly classify improvements as structure items or fixtures for several reasons:

1. Fixtures are a separate appraisal unit when measuring declines in value. (Rule 461(d))
2. Fixtures are a separate appraisal unit under new construction.
3. Fixtures are treated differently than other real property (i.e., structure items) for supplemental roll purposes.
4. Fixture value, but not structure value, is a component in the value criterion for determination of a mandatory audit.

Each of these reasons is discussed in detail below.

¹³¹ Section 602.

¹³² *Trabue Pittman Corp v. County of L.A.* (1946) 29 Cal.2d. 385.

DRAFT**Fixtures are a Separate Appraisal Unit when Measuring Declines in Value**

Proposition 8, passed by the electorate in November 1978, amended Article XIII A of the State Constitution to require the assessor to recognize declines in value (of real property) if market value on the lien date falls below the property's factored base year value. Section 51 requires that the assessor annually enroll the lower of either (1) a property's base year value factored for inflation; or (2) its full, or market, value as of the lien date. Thus, declines in value under Proposition 8 are determined by comparing the current full value of an *appraisal unit* to the factored base year value of the unit on the lien date.¹³³

Under the statutory definition of appraisal unit (section 51(d)), an *appraisal unit* is the unit that (1) persons in the marketplace commonly buy and sell as a unit or (2) is normally valued separately. Land and improvements, for example, are an appraisal unit because improvements are typically bought and sold with land. Fixtures not typically bought and sold separately in the market are also considered a separate appraisal unit under these sections, because they are normally valued separately (see (2) above). Rule 461(d) and Rule 122.5 explicitly define fixtures, and other machinery and equipment classified as improvements, as a separate appraisal unit when measuring a decline in value. Fixtures and machinery and equipment have been defined as a separate appraisal unit in this context because they generally have a shorter useful life and are replaced much sooner (and with greater frequency) than are land and buildings.

Fixtures are a Separate Appraisal Unit under New Construction

Property tax law specifically defines new construction of fixtures separately from new construction of other types of improvements. Therefore, fixtures are a separate appraisal unit under new construction.¹³⁴ New construction, as it relates specifically to fixtures, is defined in Rule 463(b)(5) as follows:

Any substantial physical rehabilitation, renovation or modernization of any fixture which converts it to the substantial equivalent of a new fixture or any substitution of a new fixture.

Substantial equivalency shall be ascertained by comparing the productive capacity, normally expressed in units per hour, of the rehabilitated fixture to its original productive capacity.

When a new fixture is installed or an existing fixture is replaced with a new one, there is new construction. A new base year value is established for that particular appraisal unit, even though no alterations were made to the building or land.

¹³³ Rule 461.

¹³⁴ "Fixture" is defined as an improvement whose use or purpose directly applies to or augments the process or function of a trade, industry, or profession. (Rule 463(c)).

DRAFT**Fixtures Treated Differently for Supplemental Roll Purposes**

Supplemental assessments apply to "property" when a change in ownership or new construction occurs after the lien date. Section 75.5 defines "property", it states:

"Property" means and includes real property, *other than fixtures which are normally valued as a separate appraisal unit from a structure*, and manufactured homes subject to taxation under Part 13 (commencing with Section 5800). (Italics added.)

Therefore, fixtures *are* subject to supplemental assessment only when they part of a larger appraisal unit including other real property (land and improvement) and (1) are subject to a change in ownership or (2) qualify as "new construction". Fixtures are *excluded* from supplemental assessment when they are normally valued as a separate appraisal unit per section 75.5, and are not part of a larger appraisal unit.

If an entire property is appraised and the appraised value is allocated to land, structures, fixtures, personal property, etc., the fixtures are valued as part of a larger appraisal unit. The fixtures are not being valued as a separate appraisal unit. In this case, they *are* subject to supplemental assessment as is the rest of the real property in the larger appraisal unit. On the other hand, if land and structures are appraised as one unit and fixtures are appraised separately, the fixtures are being appraised as a separate appraisal unit and *are not* subject to supplemental assessment.

Fixture Value Included in Value Criterion for Mandatory Audit

The combined total value of personal property and fixtures determines whether an audit is mandatory; the value of structure items is not included in this determination. Section 469 states:

In any case in which locally assessable *trade fixtures*¹³⁵ and business *tangible personal property* owned, claimed, possessed, or controlled by a taxpayer engaged in a profession, trade, or business has a full value of three hundred thousand dollars (\$300,000) or more, the assessor shall audit the books and records of that profession, trade, or business at least once every four years. [Emphasis added.]

Caution should be exercised to avoid misclassification. If fixtures are erroneously reported or otherwise misclassified—notably, if fixtures are classified as structures or visa versa—the value criterion for mandatory audits cannot be applied properly.

¹³⁵ Fixtures and trade fixtures are synonymous terms in this context, as discussed earlier.

DRAFT**APPRAISAL OF IMPROVEMENTS RELATED TO BUSINESS PROPERTY**

In general, improvements related to business property (i.e., landlord improvements, leasehold/tenant improvements, structure items, and fixtures) are valued, as is other real property, in accordance with section 51. As previously discussed, section 51 requires county assessors to value taxable real property at the lesser of its base year value (compounded or factored annually) or its full cash value (per section 110).

The base year value is the current market value of real property in 1975-76, or in any subsequent year based upon a change in ownership or new construction (sections 50 through 51.5, and 110.1). The base year value can be adjusted for the effects of inflation up to a maximum of 2 percent per year based on the California Consumer Price Index. For example, an improvement with a 1997-1998 base year value of \$100,000 (and a 1998 inflation factor of 2 percent) has an adjusted base year value of \$102,000 in year 1998-1999.

Base Year Value x Inflation Factor = Indexed Base Year Value

$$\$100,000 \times 1.02 = \$102,000$$

The full cash value on the lien date is the property's current market value. This value is estimated by an appraiser using an approach(es) to value allowed by Rule 3: the comparative sales approach, the stock in debt approach, the cost approach, or the income approach.¹³⁶ If the current market value of a property is below its adjusted base year value, the property is temporarily reassessed to reflect the lower value, that is, the property's current market value or its full cash value on the lien date (section 51(a)). In some future year, if and when the property's market value exceeds its adjusted base year value, the adjusted base year value will be restored to the assessment roll. Assume that the improvement mentioned above, with an indexed base year value of \$102,000, has a current market value of \$95,000. Since the market value (\$95,000) on the 1998-1999 lien date is less than the indexed based year value (\$102,000), the market value is enrolled until such time that the market value exceeds the indexed value.

Structures v. Fixtures**Structure Items**

The valuation of structure items is normally conducted by the real property appraiser since he or she has the market data, cost manuals, and requisite experience to properly value all real property. In certain circumstances, however, the auditor appraiser may be required to value this property. The auditor appraiser should refer to other handbooks (i.e., AH 501 and AH 502) to have the necessary knowledge and background to arrive at an accurate estimate of value. The discussion here will focus on the appraisal of fixtures.

¹³⁶ See AH 501, AH 502, and Chapter 4 of this manual.

DRAFT**Fixtures**

Fixtures are normally valued and assessed by the auditor appraiser. As a general rule, fixtures are (1) a separate appraisal unit for declines in value and new construction, (2) valued differently than other improvements, and (3) included in the total cost making up a mandatory audit. Additionally, since fixtures are property that directly apply to or augment the process or function of a trade, industry, or profession, it follows that fixtures should be valued by the same appraiser (or auditor appraiser) valuing other business property.

In most cases, concerning fixtures, the lower value is the full cash value on the lien date. This is the current market value of the property estimated by the auditor appraiser using an appropriate approach to value (the cost approach, the comparative sales approach, or the income approach).

In valuing improvements related to business property (including structure items and fixtures), careful consideration should be given to new construction, leasehold improvements abandoned on the lien date, and fixtures which have declined in value. Several issues and questions arise and should be addressed regarding these types of improvements. The following discussion addresses these issues.

New Construction

"Any addition to real property, whether land or improvements (including fixtures), since the last lien date" is new construction pursuant to section 70 (a)(1).¹³⁷ The appraisal of new construction, as related to real property, is discussed in AH 502, *Advanced Appraisal*. It is important to mention new construction here, however, because it affects improvements related to business property and may concern both the auditor appraiser and real property appraiser.

When new construction of landlord and/or leasehold improvements has occurred, the information may be received by the assessor from different sources. As indicated earlier, information may originate from (1) the Business Property Statement (Schedule B) as reported by the taxpayer, (2) building permits, or (3) county health permits required for some types of construction. The Business Property Statement is received by the business division, and building permits are received by the real property appraisal division. A taxpayer may report information on the property statement that has also been provided to the real property appraiser in the form of a permit (and perhaps a follow-up construction activity questionnaire to the taxpayer). Since information is received by both divisions, the landlord and/or leasehold improvements may be assessed by both divisions (or may escape assessment) if a system of effective coordination is not in place. Methods for ensuring such coordination are discussed later in this chapter.

After the information regarding construction activity is received, improvements should be classified as a structure item or fixture.¹³⁸ The descriptions of additions and deletions should be reviewed by both an auditor appraiser and real property appraiser and valued appropriately.

¹³⁷ See also Rule 463.

¹³⁸ See "Why Classification is Important" which is discussed earlier in the chapter.

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- 1 The following example illustrates fixtures qualifying as new construction because they are
 2 additions since the last lien date.

Example 5.1 : Valuation of New Construction (Fixtures)

On February 1, 1997, a taxpayer purchased and installed a new walk-in refrigerator (not an integral part of the building). The total installed cost of the refrigerator was \$10,000. At acquisition, it had an estimated average service life of 12 years. The inflation factor for the current year is 2%.

What is the assessed value on the 1998 lien date, January 1, 1998?

	<u>Cost</u>	<u>Index Factor</u>	<u>Percent Good Factor</u>	<u>Fair Market Value</u>	<u>Inflation Factor</u>	<u>Indexed Value</u>
Total 1997 Cost	\$	100	.94	<u>\$ 9,400</u>		
Total 1997 Cost	\$				1.02	<u>\$ 10,200</u>
Enrolled Value				<u>\$ 9,400</u>		

What is the 1997-1998 supplemental assessment value?

No supplemental assessment applies to these fixtures. The fixtures are a separate appraisal unit, and are not part of a larger appraisal unit; therefore, the property is not subject to supplemental assessment.

Remodel and Repair

New construction also includes "any alteration of land or of any improvement (including fixtures) since the last lien date, which constitutes a major rehabilitation thereof or which converts the property to a different use."¹³⁹ Thus, new construction may include remodel and repair of improvements where:

1. the "physical alteration...converts the improvement *or any portion thereof* to the substantial equivalent of a new structure or portion thereof or changes the way in which the portion...had been used,: (Rule 463(b)(3)), or
2. there is "substantial physical rehabilitation, renovation, or modernization of any fixture which converts it to the substantial equivalent of a new fixture" (Rule 463(b)(5)).

The phrase, *or a portion thereof*, refers to one machine or even a series of machines that perform a distinct function or process in a trade, industry, or profession. The unit of appraisal can be a lathe, a drill press, an entire processing line, or the initial store fixtures in a commercial establishment. Thus, "replacement" of the unit, or "restoration/repair of" or "remodeling" the unit to substantially equivalent to new, constitutes new construction to *a portion thereof*.

¹³⁹ Section 70 (a)(2).

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1 *Substantial equivalency* shall be ascertained by comparing the productive capacity, normally
 2 expressed in units per hour, of the rehabilitated fixture to its original productive capacity."¹⁴⁰
 3 "Repair" or "renovation" to a part of the unit only (i.e., a new gear for the lather or drill press),
 4 does not qualify as *the substantial equivalent of a portion thereof*. In addition, "remodel" or
 5 "replacement" that is performed solely for the purpose of normal or routine maintenance in order
 6 to continue the use or function of the unit (i.e., a new roller to replace the old one in a printing
 7 press) is not considered new construction.

8 Remodeling is a change of plan, form, or style of a structure or unit to correct functional or
 9 economic deficiencies. A remodel is frequently an interior or exterior "facelift", changing the
 10 theme, name, spatial relationships, or atmosphere; landlord improvements and/or leasehold
 11 improvement are removed and new improvements are added, even though there is little or no
 12 physical deterioration. To value such property, an appraiser would delete the old property's
 13 enrolled value and enroll the new property at its current market value as of the date of completion
 14 of the remodel. The appraiser should account for both the removals and the additions when
 15 estimating any added value as a result of a remodel or repair:

16 **Original Value - Net Value of Removal + Value of New Improvements = New Value**

17 Similar to other types of new construction, information on remodeling and repair is received
 18 from different sources and distributed to different divisions of the assessor's office. This is
 19 another occasion for the real property appraiser and the auditor appraiser to coordinate their
 20 efforts. Costs must be evaluated by the appropriate appraiser(s) in several ways: (1) have any
 21 demolition costs been excluded; (2) are they other elements of cost, such as redecoration or
 22 normal maintenance, which should be excluded; (3) to what extent do the alterations,
 23 replacements, renovations add value to the property. Answers to these questions aids the
 24 appraiser(s) in determining the proper assessed value. For example, costs associated with normal
 25 maintenance and repair, which may only ensure the continued use of the existing improvement
 26 would not be included in the value of the new construction. Major repairs adding to the life or
 27 utility of the improvement may affect the value. The rule and handbook guidelines in regard to
 28 the valuation of new construction are instructive.

29 **Valuation of Abandoned Leasehold Improvements**

30 Improvements installed by a tenant, but left at a vacant rental space are *abandoned leasehold*
 31 *improvements*. The real property appraiser and/or auditor appraiser may encounter difficulties
 32 when assessing this property. For example, to whom are the structure items and fixtures
 33 assessed, and what is their value? No two cases will be the same. Facts related to each scenario
 34 will differ and appraisal must be based on those facts.

35 Following is an example of one possible scenario involving abandoned leasehold improvements.

¹⁴⁰ Section 463 (b)(5).

DRAFT**Example 5.2: Abandoned Leasehold Improvements**

A retail store moves into a new indoor mall in 1996. The mall space is leased to the tenant as a shell. It is the tenant's responsibility, and expense, to finish the space to their specifications. The retail store spends \$20,000 to install leasehold improvements. The leasehold improvements, improvements paid for by the lessee, include structure items (dropped ceiling, finished walls, lighting fixtures, and carpet) and fixtures (burglar alarm system, and permanent partitions-less than floor to ceiling).

After two years at this location, the retail store moves out of the space to another mall. The leasehold improvements installed two years earlier are abandoned and the space is left vacant on the lien date, January 1, 1998.

Because the tenant has abandoned the improvements and the leased space in the scenario above, any improvements left behind revert to the owner of the mall; therefore, the mall owner is the assessee. The structure items and fixtures are assessable to the mall owner on the lien date.

The improvements may continue to have value because, in theory, another tenant using the same space and improvements may not be required to spend the same amount of time and money in order to utilize the space for their needs. The value, on the other hand, may be less than indicated by the cost approach, since a future tenant may have different needs than the original tenant. Professional judgment is needed to determine whether the abandoned improvements have value, no value, or even negative value (a future tenant or the landlord may expend funds to remove inappropriate structural items and fixtures).

Valuation of Fixtures under Decline in Value

Measuring declines in value can be simple when only fixtures are involved. The fixtures, as the separate *appraisal unit*, are valued at current market value on the lien date and at the indexed base year value, and the lower value is enrolled. However, measuring declines in values may become more difficult in a total property appraisal because more than one appraisal unit is involved. When a decline in value(s) of such property occurs, the second paragraph of Rule 461(d) is extremely important and must be applied.

Declines in value will be determined by comparing the current lien date full value of the *appraisal unit* to the indexed base year full value of the same unit for the current lien date. (Italics added.)

In other words, each *appraisal unit* must be considered separately. The following example illustrates how declines in value and appraisal units should be treated under Rule 461(d).

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Example 5.3: Total Property Appraisal Under Decline in Value			
	Market Value on the Lien Date	Indexed Base Year Value	Total Property Value
	(Prop 8 Value)	(Prop 13 Value)	(Assessed Value)
Appraisal Unit 1			
Land	\$515,000	\$100,000	
Building	<u>60,000</u>	<u>85,000</u>	
Unit 1 Value	<u>575,000</u>	<u>185,000</u>	\$ 185,000
Appraisal Unit 2			
Fixtures	<u>40,000</u>	<u>52,000</u>	
Unit 2 Value	<u>\$ 40,000</u>	<u>\$ 52,000</u>	\$ 40,000
Total Property Value (Unit 1 + Unit 2)			<u>\$225,000</u>

As indicated in the above example, the proper unit values are "Appraisal Unit 1" (land and building) value of \$185,000 and the "Appraisal Unit 2" (fixtures) value of \$40,000. The correct total value of this property is \$225,000. The appraisal units must be defined properly when applying Rule 461(d) and recognizing declines in value. If the appraisal units are not defined properly, the assessed value of the property would be erroneous and not in compliance with property tax law.

DETERMINATION OF ASSESSEE

When the owner of a business is also the owner of the real property, there is no question as to the proper assessee of the improvements. All property is assessed to one account (to the real property owner) on the secured roll. In the case where the owner of the real property does not own the business, however, other possibilities arise. Improvements may be constructed and paid for by either the landlord (landlord improvements) or the tenant (leasehold improvements) and in either case are assessable to either party.

When new construction of improvements occurs, the added value of the new construction is typically assessed to the party who paid for the improvements. A tenant in a shopping center, for example, is typically assessed on the unsecured roll for leasehold improvements (structure items and fixtures), since they are constructed at the tenant's expense. (Such construction is generally reported on the Business Property Statement.) On the other hand, the owner of an office building is typically assessed on the secured roll for landlord improvements since they are constructed at the building owner's expense. (Such new construction is usually discovered by a building permit.)

However, the above procedure is not a legal requirement. Section 405 allows the assessor to assess property to "the persons owning, claiming, possessing, or controlling it on the lien date."

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In the case of landlord improvements and leasehold improvements, the courts have interpreted this to mean either the lessor or lessee is the proper assessee, even if paid by the opposite party.¹⁴¹

SUGGESTED PROCEDURES FOR ASSESSING LANDLORD IMPROVEMENTS AND LEASEHOLD IMPROVEMENTS

Close cooperation of auditor appraisers and real property appraisers is essential when valuing and assessing landlord and leasehold improvements,¹⁴² because special difficulties arise concerning the uniform assessment and proper enrollment. Record management for accurate tracking of base year values and ownership of this type of property can be complex and tedious but is extremely important. As discussed earlier, information regarding this type of property is received from various sources and is often submitted to different appraisers (both auditor appraisers and real property appraisers). The value may be enrolled on either the secured roll or the unsecured roll, and the assessee may be either the landlord or the tenant.

Internal procedures in assessors' offices should establish and maintain cooperation to assure that all landlord improvements and leasehold improvements are (1) valued on and at the appropriate date and amount, (2) not duplicately assessed on one or more accounts, (3) assessed on the proper roll (i.e., secured or unsecured), and (4) assessed to the proper assessee. The means by which this coordination is accomplished may understandably differ from county to county, but general guidelines for coordination should be maintained in all assessment programs. Several suggestions for achievement of coordination regarding the assessment of improvements related to business property are discussed below.

Establish a Comprehensive Set of Written Procedures Regarding the Assessment of Landlord and Leasehold Improvements

A comprehensive set of written procedures that describes how to systematically identify and assess landlord and leasehold improvements is helpful for promoting assessment uniformity. As noted above, the assessment of landlord and leasehold improvements requires record management for proper tracking of base year values and ownership. Written procedures clarify each staff member's responsibilities in the assessment process for this type of property, making appraisal and record management easier to maintain.

Develop Memorandum for Coordination

The transfer of information is important to avoid duplicate assessment of landlord and leasehold improvements, which may include structure items and fixtures. A method used to track and monitor this transfer of information in some assessor's offices is an inter-departmental

¹⁴¹ *Valley Fair Fashions, Inc. v. Valley Fair*, 245 Cal.2d 614, *Tele-Vue Systems, Inc. v. Contra Costa County*, 25 Cal.App.3d 340, and *Ventura County v. Channel Islands State Bank*, 251 Cal.App.2d 240.

¹⁴² The State Board of Equalization assesses leasehold improvements to state assesseees. Coordination with the Boards Valuation Division should be made if leasehold improvements are reported to your county in order to avoid a double assessment.

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memorandum. This memorandum is sent between departments (i.e., between the real estate division and business division) with a copy of the improvement source document. The memorandum includes three copies; one copy kept by the originator to verify completion of the assessment, one copy for the real property file, and one copy for the business property file.

The intent of the memorandum is to provide a complete record of the appraisal of the improvements, including classification, valuation, and assessee. It summarizes all appraisal information for the business file and real property record. The following example illustrates how an inter-departmental memorandum may be used in practice.

Example 5.4: Inter-departmental Memorandum
<ul style="list-style-type: none"> • A property statement is received by the business division and additions are reported on schedule B. The auditor appraiser initiates a memorandum regarding these additions. • The original memorandum (copy #1) is kept by the originator (auditor appraiser). Copies #2 and #3 are attached to a copy of schedule B and forwarded to the real property division. The original (copy #1) is maintained by the auditor appraiser to track the appraisal of the improvements. • The real property appraiser uses the memorandum with attachments to determine any applicable value changes. Copy #2 of the memorandum is attached to the real property file after the real property appraiser has made the valuation. • The real property appraiser uses the final memorandum (copy #3) to notify the business division of the appraisal with any recommended action needed by the auditor appraiser.

Clearly Identify Landlord and Leasehold Improvements on Appraisal Records

Proper notes on appraisal records concerning the establishment of value is an important final step in the coordination process. Appraisal notes should include information regarding the existence of landlord and leasehold improvements, a description of the improvements, and the basis for valuation. If the improvements involve more than one account, the appraisal records should indicate in what manner the improvements are assessed (i.e., to whom, secured roll/assessor's parcel number, unsecured roll/business property account number). This will not only assist appraisers and auditor appraisers who may work on the subject parcel or related business account(s) in the future, but will also help to avoid duplicate or escape assessments.

Suggested Method and Example

Appendix XX describes and suggests one method of coordinating the appraisal of landlord and leasehold improvements that is used in some assessors offices. It is not the only proper method. An example is included as illustration. The example starts with the source documents and goes through several steps including classification, determination of assessee, valuation, and enrollment of value.

DRAFT**CHAPTER 6: SPECIAL ISSUES****VALUATION OF OTHER TYPES OF PERSONAL PROPERTY****LEASED EQUIPMENT**

Valuation and assessment of leased equipment can be one of the more difficult tasks an auditor appraiser encounters.¹⁴³ Many impediments are generated by a lack of complete, up-to-date information. Other problems are based on the nature of the property. Leased equipment is usually easily movable, and it tends to change ownership (or possession) and situs frequently. This can make it difficult to analyze some or all of the factors (taxability, assessee, situs, description, classification, security, and value) necessary to make a valid assessment. At least four of these seven factors tend to change on a regular basis: taxability, assessee, situs, and value; thereby changing the resulting assessment.

Taxability

Taxability of leased equipment, or equipment intended for lease, is the first consideration an appraiser encounters. As discussed in Chapter 1, personal property leased on the lien date is taxable unless exempt. However, personal property held for lease on the lien date is inventory. Leased equipment, or property intended for lease, is taxable when:¹⁴⁴

- property is actually leased or rented on the lien date.
- property is being used by the owner for purposes not directly associated with the prospective sale or lease of that property.
- property has been used by the owner prior to the lien date, even though "held for lease" on the lien date.
- property is intended to be used by the lessor after being leased (or during intervals between leases), even though "held for lease" on the lien date.

Assessee

A person who owns, claims, possesses, or controls property on the lien date is the assessee of that property. This is either the lessor or the lessee. Under section 405, the assessor may assess leased property to either, or both, whether or not there is a private agreement between the parties to the lease. Section 405 specifically states:

¹⁴³ Leased equipment reported to the State Board of Equalization by public utility companies are assessed at the state level. However, the Board may delegate to a local assessor the duty to assess a property used but not owned by a state assessee on which the taxes are to be paid by a local assessee.

¹⁴⁴ See Rule 133(b), *Business Inventory Exemption, Exclusions*.

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(b) The assessor may assess all taxable property in his county on the unsecured roll jointly to both the lessee and lessor of such property.

(c) Notices of assessment and tax bills relating to jointly assessed property on the unsecured roll shall be mailed to both the lessee and the lessor at their latest addresses known to the assessor.

However broad this statute, the courts and most counties have reasonably construed the language.¹⁴⁵ That is, property is generally *not* assessed jointly although the assessor has that option pursuant to section 405. Property under true lease is usually assessed only to the lessor and property under conditional sales contract only to the lessee. Exceptions to this rule mainly occur when the lessor requests to be assessed to ensure the taxes are paid or one of the parties to the lease is an exempt entity.

Leasing with Exempt Entities

Banks and Financials

Tangible personal property owned by banks and financial corporations (commonly referred to as financial institutions or financials) is exempt from property taxation by the in-lieu tax provisions under article XIII, section 27 of the California Constitution, and sections 23154, and 23181-23183 of the Revenue and Taxation Code. These businesses pay an in-lieu "franchise tax on net income" instead. A listing of banks and financials qualified under these sections is maintained by the Franchise Tax Board with confidential copies distributed to assessors annually by the Board of Equalization. The in-lieu exemption does not apply to banks and financial corporations whose principal activity consists of leasing tangible personal property (see section 23183(b)). Generally such corporations are not shown on the list. Any questions in this regard should be directed to the Franchise Tax Board.

If a lessor bank or financial is shown in the listing, the leased property is taxable to the lessee (unless the lessee is also exempt from property taxation) pursuant to section 235. Section 235 states:

For purposes of this division, the lessee of tangible personal property owned by a bank or financial corporation shall be conclusively presumed the owner of that property.

However, where personal property is leased to an exempt bank or financial, it is taxable to the owner/lessor (unless the owner/lessor is also exempt from property taxation) since the exempt bank or financial is the lessee. The owner/lessor holds title to the property and does not benefit from the lessee's in-lieu exemption.

¹⁴⁵ Attorney General Opinion CV 78-58 November 3, 1978, (pg. 475).

DRAFT**1 Insurance Companies**

2 Personal property owned by insurance companies is exempt from property taxation, regardless of
 3 how the property is used by that insurance company, pursuant to article XIII, section 28, of the
 4 California Constitution.¹⁴⁶ Property leased to insurance companies, rather than owned by them,
 5 however, remains assessable to the lessor (unless the lessor is also exempt from property
 6 taxation).

7 Government Entities

8 Property leased to or from a federal, state (California), or local governmental (county, city,
 9 district in California) entity is not taxable to that entity, although the property may remain taxable
 10 to another party. It is not taxable to the governmental entity because:

- 11 • The federal government is immune from taxation pursuant to the United States
 12 Constitution; "it is a governing constitutional principle that the properties, functions, and
 13 instrumentalities of the federal government are immune from taxation by state and local
 14 government."¹⁴⁷
- 15 • The California Constitution, article XIII, sections 3 through 5 expressly exempt from
 16 taxation all property *owned* by the state or local governments, except as provided in section
 17 11(a) of the California Constitution, article XIII (which applies only to land and
 18 improvements outside the boundaries of the local government).

19 Personal Property

20 Personal property owned by the government is immune (federal) or exempt (state or local) from
 21 all taxation, as discussed above, and it is not subject to possessory interest as is real property
 22 (with one exception).¹⁴⁸ "The legislature has not defined personal property as including a right to
 23 its possession as it has real property".¹⁴⁹

24 Privately owned personal property leased to and held by the government is *not* immune (federal)
 25 or exempt (state or local) where title remains with the lessor. In such cases, the property is
 26 taxable to the owner/lessor, even if its situs is located on government-owned land. (The
 27 exceptions are Congressional grants of immunity for the privately held personal property of
 28 Indians located on Indian reservations and personal property located on federal enclaves.)

29 Frequently in cases where federal immunity or state/local exemption is claimed regarding leases of
 30 property with the government, the question is whether the property is actually "owned" by the
 31 government. Whether the government is the lessor or the lessee, the question is one of fact; who
 32 "owns" the property? In one case, for example, a court found that title to tools, equipment, and

¹⁴⁶ *Mutual Life Insurance of New York v. City of Los Angeles* (50 Cal.3d 402) overturned *Massachusetts Mutual Life Ins. Co. v. City and County of San Francisco* 129 Cal.App.3d 876

¹⁴⁷ *TRW Space & Defense Sector v. County of Los Angeles* (1996) 50 Cal.App.4th 1703, p. 1704(1).

¹⁴⁸ See section 201.5.

¹⁴⁹ *General Dynamics Corp. v. Los Angeles County* (1958) 51 Cal.2d 59. An exception is set forth in section 201.5 for personal property owned by or for the California Pollution Control Financing Authority.

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material owned by federal government but used by a private contractor doing government construction remained with the government and were therefore immune from taxation.¹⁵⁰ In another case, a court found that title to personal property consisting of materials and inventory used by a private contractor doing government construction never vested in the government, even though the government fully reimbursed the costs to the contractor. The nature of the property involved was mere overhead, "the common staples of any ongoing business; the contractor was the owner."¹⁵¹

Where the question of ownership is not clear, proper analysis of the lease agreements and other sales or financing documents is important. In establishing ownership for tax purposes, the assessor should determine who holds the *essential indicia of ownership*.¹⁵²

A title clause standing alone is not conclusive of ownership for tax purposes when it appears that the taxpayer retains the *essential indicia of ownership*... Accordingly, it is necessary to examine the terms of the contracts to determine whether plaintiffs retained rights in the property inconsistent with its ownership by the United States for tax purposes.¹⁵³ (Italics Added)

Several factors have been identified by the court(s) under the *essential indicia of ownership* test as evidence that the government holds title. The tests can be applied when the government is either the lessor or the lessee to the contract if title is not physically held by the government. When the government is a lessee, for example, *essential indicia of ownership* may be apparent if:

1. title automatically passes to the government (lessee) at the end of the lease term (the title clause of the lease agreement);
2. the property itself is used as security for any unpaid lease payments (in the event of default, the lessor would sell the property to pay off the debt and the remainder would go to the government);
3. the government (lessee) has full authority to alter the property at will;
4. the government (lessee) is required to maintain the property.

Again, no one factor standing alone is indicative of *essential indicia of ownership*, or proper owner for property tax purposes. The ultimate decision must be made on consideration of all the facts.

¹⁵⁰ *General Dynamics Corp. v. Los Angeles County* (1958) 51 Cal.2d 59.

¹⁵¹ *TRW Space & Defense Sector v. County of L.A.* (1996) 50 Cal.App.4th 1703.

¹⁵² *Mayhew Tech Center Phase II v. County of Sacramento* (1992) 4 Cal.App.4th 497

¹⁵³ *General Dynamics Corp. v. County of L.A.* (1958) 51 Cal.2d 59.

DRAFTFixtures (and other real property)

Fixtures owned by the federal government and leased to a private party are immune (federal) or exempt (state or local) from property taxation, to the same extent as other real property. Fixtures are not assessable to the government owning the property, but are assessable to the lessee as a *possessory interest* as any other type of real property leased from the government. The assessment is on the interest of the lessee based on the value of the entire leased property, excluding personal property. It is a *possessory interest* in real property.¹⁵⁴ A possessory interest within an area in which the United States has exclusive jurisdiction (so-called "federal enclaves") is excluded from the meaning of "taxable possessory interest" and is immune from taxation.

Thus, determination of ownership becomes less of an issue; the property is either assessable as an improvement value or a possessory interest value. If, however, ownership does become an issue, it should be determined based the *essential indicia of ownership* as discussed above.

Summary of Leases with a Governmental Agency as Lessor of Lessee

The following table summarizes the discussion regarding leases with the federal, state, or a local government agency as either lessor or lessee. The table is not controlling in all situations and, again, *essential indicia of ownership* (referred to as *owner (title with)* in the table) should be determined based on all facts.

¹⁵⁴ Section 107.

DRAFT**Table 6A: Assessability of Leases Involving Government**

LESSOR	LESSEE	OWNER (TITLE WITH)	TYPE OF PROPERTY	ASSESSEE
Private Party	Government	Lessor	Personal Property	Private Party
Private Party	Government	Lessee	Personal Property	No assessment (Immune or Exempt)
Private Party	Government	Lessor	Fixtures (and other real property)	Private Party
Private Party	Government	Lessee	Fixtures (and other real property)	Private Party (Possessory Interest)
Government	Private Party	Lessor	Personal Property	No assessment (Immune or Exempt)
Government	Private Party	Lessee	Personal Property	Private Party
Government	Private Party	Lessor	Fixtures (and other real property)	Private Party (Possessory Interest)
Government	Private Party	Lessee	Fixtures (and other real property)	Private Party

1

2 ***Other Exempt Entities or Institutions***

3 Property leased to other exempt entities and institutions may be eligible for exemption, but each
4 situation must be considered individually. In some cases the property may be automatically
5 exempted; in others, claim forms must be filed in order for the applicable exemption or reduction
6 to be granted. For example, a lessor who leases equipment to public libraries, museums, schools,
7 community colleges, state colleges, and the University of California is not automatically exempt
8 from taxation on the property. The lessor may file a claim for exemption if (1) the leased
9 equipment is "used exclusively" by an aforementioned entity as lessee and (2) it is demonstrated
10 that the benefit of the exemption has inured to the lessee institution. Where the lessor does not
11 claim the exemption, the lessee must file a claim in order to receive the refund of tax that the
12 lessor has paid to the county (Section 202 et seq. and 203).

13 A comprehensive discussion of exemptions is not appropriate for this section of the Assessors'
14 Handbook. Reference to exemptions' handbooks and code sections governing exemptions
15 (sections 202, 203, 214 et seq.) is necessary to determine whether equipment leased to qualifying
16 entities is automatically eligible or if a claim must be filed.

DRAFT**Situs**

Physical situs of leased equipment may change frequently, as previously discussed in Chapter 3. Determination of taxable situs of this property is generally governed by Rule 204 and section 623.

Prior to January 1, 1997, Rule 204, *Leased Equipment*, was the sole authority governing this determination. It requires a determination of a *precise* situs for each piece of equipment (a time consuming process in many cases). However, a recent amendment to section 623 has made *precise* situs of leased equipment less important by allowing a single assessment for leased personal property:

The assessor *may* place a single assessment on the roll for all leased personal property in the county that is assessed with respect to the same taxpayer. Any property assessed pursuant to this section shall, in the absence of evidence establishing otherwise, be deemed to be located at the taxpayer's primary place of business within the county. (Italics Added)

Description: Types of Leases

A lease is generally defined as any contract that gives rise to a lessor and lessee relationship in real or personal property. There are many different types of leases and lease situations. To properly determine property tax reporting and assessment questions, it is important to define and consider each type of lease, and the terms associated with them: short-term leases, extended-term leases, true leases, and financing leases or conditional sales contracts.

Short-Term Leases

Leases or rentals of property on a daily, weekly, or other short-term basis (defined as a period of less than 6 months) are short-term leases. The property is assessable to the lessor at the lessor's principal location, regardless of actual location or control on the lien date.¹⁵⁵ The lessor is considered the owner, and value is estimated by reference to the owner's cost of the property.¹⁵⁶

Extended-Term Leases

An *extended-term lease* (commonly referred to as *long-term lease*) is any lease whose duration is six months or more. Many of this leased property will eventually become the property of the lessee. For example, a lessee leases a computer for five years. At the end of the five-year lease period, the lessee has the option to buy the computer for \$1. Essentially, from the start of the lease, the lessee is the owner of the equipment whether or not title has actually passed. These leases may be assessable by the assessor to either the lessor or the lessee, and their situs is generally their actual location.

¹⁵⁵ Rule 204.

¹⁵⁶ See trade level discussion in Chapter 4.

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Extended-term leases, business property leased for a term of more than six months or for an extended (even though unspecified) period, must be valued as if in the hands of the lessee, after all costs of production, including marketing costs, profits, and sales tax, have been added. The lessee is considered the consumer of the property, and the property is therefore valued at the consumer trade level. In the example above, the lessee may record a \$1 buy-out cost on their books. The actual value for property tax purposes should be based on the total acquisition cost at the inception of the lease (if the cost approach is utilized) or total payments made during the lease (if the income approach is utilized).

True Leases

True leases, whether short-term or extended-term as defined above, are agreements under which an owner gives up possession and use of his property for valuable consideration and for a definite term and at the end of the term, the owner has the absolute right to retake, control, or convey the property.¹⁵⁷ It is an agreement under which there is no intention of transferring ownership. At termination of the lease, the property will be returned to the lessor.

Conditional Sales Contracts or Financing Leases

Conditional sales contracts or financing leases (agreements) are purchases rather than true leases. They can be short-term or extended-term agreements whereby the seller (vendor) agrees to periodic payments on account of the purchase price while retaining legal title to the property. Possession of the property transfers to the buyer (vendee) without full legal title until payment of the purchase price or a predetermined date occurs.¹⁵⁸

They are contracts that provide use and control to a buyer with the seller retaining title as security for payment. The buyer or lessee is the beneficial owner of the property, and therefore becomes the proper assessee, regardless of whether they hold title.

Differentiating Between a True Lease and a Conditional Sales Contract

It is often difficult to distinguish between a true lease and a conditional sales contract, and no precise formula has been devised for separating the two types of contractual arrangements.¹⁵⁹ An agreement identifying itself as a lease may, in actuality, be a conditional sales contract and vice-versa. The distinction, however, may be of prime importance. Taxability, exempt status, and appropriate assessee may be based on the distinction (and thus ownership).

According to the Uniform Commercial Code, in determining whether an instrument is a lease or a sales contract, the contract form is not as important as the intent of the parties. Following are some issues related to the lease contract that will help determine the intent of the parties of the contract. In any contract, some of the issues may be indicative of a true lease while others may be indicative of a conditional sales contract. The intent of the parties should be determined by the express terms of the contract. Some terms such as liability for insurance, taxes, and other

¹⁵⁷ *Blacks' Law Dictionary*, Sixth Edition, p. 890.

¹⁵⁸ Miller & Starr, *California Real Estate* 2d "Specific Real Estate Contracts, section 2:42.

¹⁵⁹ Attorney General Opinion No. CV 78-58 - November 3, 1978, page 472.

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1 expenses may not establish ownership. These terms are, therefore, not considered in the table
 2 below.

Table 6B: Issues to Review when Verifying Lease Type (True Lease v. Conditional Sales Contract)			
ISSUE		True Lease	Conditional Sale
Lease Period	<ul style="list-style-type: none"> Lease period is approximately the same as the anticipated life of the property. Lease is for a fixed period with a nominal option payment (i.e., \$1) required to transfer title. Lease is cancelable on a monthly or annual basis. Optional purchase clause is at market value. 	 X X	 X X
Rent	<ul style="list-style-type: none"> Contractual rental payments are equal to or greater than the current purchase price. Contractual rental payments are considerably less than the purchase price. 	 X	 X
Ownership Terms	<ul style="list-style-type: none"> The contract contains specific provisions retaining ownership with the lessor. The contract transfers all ownership responsibility, with the exception of title, to the lessee. 	 X	 X
Accounting Treatment By Lessor or Lessee (FASB 13)	<ul style="list-style-type: none"> Lessor is treating the property as a depreciating asset. Lessor is treating the property as an account receivable. 	 X	 X

3

4 As mentioned earlier, like any factual determination, analysis of any one item cannot determine
 5 lease type. All evidence must be weighed. Reliance on any one factor may lead an appraiser to
 6 the wrong conclusion. For instance, treatment (by either the lessor or the lessee) for financial
 7 accounting purposes can be misleading.

DRAFT**Statement Of Financial Accounting Standards No. 13 (FASB 13)**

Accounting for leases can be a controversial area of financial accounting. Many lessees structure their lease agreements to avoid capitalization for financial accounting purposes or to improve their financial position. The Statement of Financial Accounting Standards No. 13 (FASB 13) was developed to govern accounting for leases. This standard, FASB 13, provides lessees and lessors with an established criteria for classifying leases and also requires reporting and disclosure of leases on financial statements based on the classification made by the lessor and/or the lessee. Thus, when an audit is conducted, or taxpayer's records are reviewed, leased equipment can be identified. The nature of the leasing arrangement and activities must be disclosed regardless of the lease type.

Recognition of these requirements for classifying and reporting leases for financial accounting purposes under FASB 13 is useful in that a substantial amount of information about the property may be discerned. However, such information does not necessarily determine property tax classification, assessability, or value. Accounting records alone are not conclusive, although they may greatly assist the auditor appraiser in gathering and evaluating all of the facts. A lease, for example, does not necessarily need to be capitalized for it to be assessed to the lessee. Possession, claim, or control alone may determine the assessee (section 405).

Thus, accounting treatment is not necessarily a conclusive factor when considered alone based on FASB 13. None of the factors should be considered alone. All evidence must be weighed.

Valuation of Leased Equipment

When valuing leased equipment, all three approaches to value should be considered: the replacement or reproduction cost approach, the comparative sales approach, and the income approach. Each approach, when appropriate, should be applied as discussed in Chapter 4 of this section.

Regardless of which approach(es) is used, leased property must be valued at the proper trade level. As also discussed, in Chapter 4, but particularly important for leased equipment, the proper trade level depends on the term of the lease. Under extended-term leases (six months or more), the lessee is considered to be the consumer of the equipment and thus is assessable at his level, the consumer trade level. The appraiser should determine the selling price new of the equipment to consumers, plus sales tax and delivery and installation costs; then adjust for depreciation. In short-term leases or rentals (less than six months), the lessor is considered to be the consumer of the equipment, and the value is determined at the lessor's trade level.

DRAFT**SUPPLIES**

Supplies are classified as personal property.¹⁶⁰ The historical cost of supplies on hand as of the lien date is reportable by the taxpayer on the Business Property Statement.

Normally, the value of supplies can be based on cost information and/or physical examination of supplies on hand. The cost approach is an appropriate approach to value because of the relatively short economic life of the property. Current purchase price often reflects value. In some cases it is necessary to adjust the purchase price or recorded cost to include supplies not included in taxpayer's books, to adjust for trade-level, or to adjust for discounts. However, these adjustments tend to be minor and occur primarily as a result of an audit.

It is important, when utilizing the cost approach and the taxpayer's accounting records, to ensure that inventory is not misclassified or reported as supplies. Supplies should not be confused with inventory. Supplies are items used in the ordinary course of business but not incorporated into the product which is sold or leased. Inventory, on the other hand, are products held for sale or lease, which include items incorporated into those products or transfer with those products. An in-depth discussion of this topic is included in Chapter 2, *Classification*, of this section.

When appropriate cost information has been gathered and proper classification is determined, then the assessable supplies' cost can be estimated by the Percentage of Annual Purchases method. This method summarizes total yearly supplies purchased, and estimates the supplies turnover rate based on frequency and quantities of supplies purchased during the year. Total supplies purchased divided by this supplies turnover rate (Total Supplies / Turnover Rate = Estimated Supplies on Hand) generally results in a reasonable estimate of the value of the supplies on the lien date. This estimate can then be verified in the physical inspection of the business when an audit is conducted.

CONSTRUCTION IN PROGRESS

Construction in progress (CIP) is also an item required to be reported on the Business Property Statement. CIP is assessable at full cash value on the lien date.¹⁶¹ The income and sales comparison approach are of limited use because property under construction is typically not producing any income, and it is difficult to find comparable sales of partially completed projects. For this reason, the cost approach is nearly always used this type of property. Costs incurred as of the lien date are included in the total assessable cost, including preliminary direct and indirect costs such as planning and engineering charges. On the other hand, the cost may be more or less than the actual market value on the lien date. Ultimately, the value should be based on what the property in its partially-constructed condition would bring in the market place involving a willing buyer and seller. The seller would attempt to recover all costs if the equipment under construction was sold in a partially constructed state.

¹⁶⁰ See discussion of supplies in Chapter 2 for determination of items included in assessable supplies.

¹⁶¹ Construction-in-progress regarding personal property is assessable only when actual construction has begun by the lien date. If actual construction has not yet begun, any costs incurred (i.e., engineering fees) are exempt from taxation for the entire year.

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The instructions on the Business Property Statement request an attachment of an itemized listing of costs for construction in progress for improvements to land, machinery, equipment, furniture, buildings or other improvements, or leasehold improvements. Reported CIP may include both real property and personal property items which may be hard to distinguish depending on the stage of completion. Reported costs may also include direct and indirect costs which were discussed earlier in Chapter 4, *Valuation of Personal Property*, which may or may not influence value. It is important to review the costs included in CIP to determine assessability, classification, and contribution to value. Coordination between the real property appraiser and the auditor appraiser is important to correctly categorize the reported cost and to avoid duplicate assessments and escaped assessments (see Chapter 5 for more information on this topic).

COMPUTER AND RELATED

Computer and related equipment must be reported separately from other types of personal property on the Business Property Statements. This equipment includes non-production computers (excluding computer operated machinery and equipment), monitors, printers, scanners, disk drives, and cables. All of these items have relatively short-lives, and are influenced by rapidly changing technology and user needs.

Production computers (computer operated machinery and equipment or computers embedded in machinery) are not reported, considered, or valued with other computer equipment on Schedule A, column 5, *Computers*. Rather, they are valued as other types of machinery and equipment specific to that industry, and normally reported on Schedule A column 1, *Machinery and Equipment for Industry, Profession, or Trade*. Production computers may have a shorter, equal, or longer life and/or value than non-production computers. In some cases, computer-driven equipment depreciates more quickly than traditional equipment. In other cases, computer-driven equipment has made traditional equipment obsolete. Therefore, when computerized equipment is encountered, a special study of the equipment and the industry it serves may be required to determine the appropriate valuation method.

General Valuation Of

Valuation of computers and related equipment, non-production computers, has become increasingly important and difficult in many business property assessments due to rapid changes in technology and changing needs of users. Because of the typically short-lives, rapid depreciation, and little salvage value in many circumstances, the Board has provided three separate valuation tables to aid the appraiser using the cost approach to value. These tables segregate computers by original cost, and apply different factors based on past value trends. As with most equipment, these factors are not appropriate for all computers. In some cases, other approaches to value will be more appropriate. Sound appraisal judgment is necessary to determine the appropriateness of applying the factors to specific computers and estimating the accuracy of the resulting value.

DRAFT**Software**

California statutes require computer software to be classified as either basic operational programs or processing programs. Basic operational programs are taxable when they are contained on storage media; processing programs are exempt.

Section 995 describes the valuation of storage media and defines the terms "storage media" and "computer program." Section 995 requires that storage media be valued as if there were no software programs on it. The one exception is that storage media may include the value of basic operational programs when those programs are stored on it. Section 995.2 defines the terms "basic operational program" and "processing program." Rule 152 explains how to properly determine the classification of computer software.

Basic Operating Programs

Basic operational programs are those programs that are "fundamental and necessary to the functioning of a computer." They are, according to section 995.2:

that part of an operating system including supervisors, monitors, executives and control or master programs which consist of the control program elements of that system.

The assessable value of basic operational programs includes the value of the storage media *and* the value of the program embedded on it. Examples of basic operational software are basic input output system (BIOS) and licensed internal code (LIC).

In many transactions computer equipment is purchased or leased at a single price. When the price is not segregated, or able to be segregated, between taxable and nontaxable property and programs, the total purchase price may be used as an indicator of taxable value or assessable cost.¹⁶² Pursuant to Rule 152(f), when a taxpayer can identify and segregate the costs (and supply information to support such separation) the value must be adjusted appropriately.

The proper assessee is determined by the ownership and control of the storage media. It is the "storage media" and the basic operational programs contained on it that are the "taxable property". The value is assessable to "the person owning, claiming, possessing, or controlling the storage media on the lien date."¹⁶³ Storage media shall not be assessed to the owner of the copyright of the computer program embodied or stored on the media unless the owner of the copyright also owns, claims, possesses, or controls the storage media on the lien date. If the licensee of a basic operational program owns the storage media on which a program is stored, then the licensee is the proper assessee. If the storage media is leased, then the assessor has the option of making the assessment to the owner (lessor), the lessee, or to both according to section 405(b).

¹⁶² Rule 152(e).

¹⁶³ Section 405.

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2 A processing program is a program used to develop and implement the specific applications which
 3 the computer is to perform. Its operation is possible only through the facilities provided by the
 4 basic operational program (or control program). By itself, a processing program is not
 5 fundamental and necessary to the functioning of a computer.

6 The assessable value of these programs is only the value of the "storage media", as if there were
 7 no computer programs on them. This value is assessable to "the person owning, claiming,
 8 possessing, or controlling on the lien date."¹⁶⁴

9 SPECIAL CONSIDERATIONS**10 IDLE, UNUSED, OR OBSOLETE EQUIPMENT**

11 Idle, unused, or obsolete equipment has value, even if only a salvage value.¹⁶⁵ Therefore, the
 12 assessor must estimate value and include it in the assessment. Idle, unused, or obsolete
 13 equipment may need to be valued separately from in-use, active equipment of a similar type.

14 An appraiser must consider why equipment is idle or otherwise not being used. This may or may
 15 not influence value for property tax purposes, and it may or may not already be taken into
 16 consideration under the cost approach as part of the table factors (or in any other approach to
 17 value that was employed). For example, consider a printing press no longer in use because it was
 18 replaced by a newer model. The old press is stored in the office break room because there is no
 19 other place to put it until sold, donated, or otherwise disposed of. The older model has value
 20 although not in productive use and the value can be computed in the same manner as a similar
 21 piece of equipment that is in productive use. On the other hand, consider a second example of a
 22 printing press no longer in use because it needs repair. Assume the part needed to repair the press
 23 is no longer manufactured; there is no way to repair the part or the printing press; and it would
 24 not interface with modern equipment in use if it were repaired. This printing press has value, but
 25 the value may only be the salvage value of the property, or the value of the tangible materials
 26 since the printing press in essence is unusable or obsolete. As illustrated here, to value idle,
 27 unused, or obsolete equipment an appraiser must determine the reason(s) for non-use. It
 28 influences value and the resulting assessment.

29 EQUIPMENT PURCHASED USED

30 Valuation of equipment purchased used is peculiar in that the equipment index and percent good
 31 factors may or may not produce results reflective of market value. This may be due to the
 32 difference between total economic life and remaining economic life, and historical cost (cost to
 33 the original owner) and original cost (cost to current owner). The equipment index factors
 34 provided by the Board (in AH 581) include separate tables for new and used agricultural and

¹⁶⁴ Section 405.

¹⁶⁵ This discussion could also be applied to the valuation of equipment that is abandoned in place, and back up equipment.

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1 construction equipment, but does not include separate tables for other types of equipment. An
 2 appraiser should take care to determine how the results of applying factors, both trending and
 3 estimation of depreciation, relate to the actual market value of equipment purchased used. If the
 4 results are not indicative of market value, another method of estimating depreciation, as
 5 discussed in Chapter 4, or another valuation approach should be utilized.

6 Another method of estimating cost and implementing the equipment index factors and percent
 7 good factors, used infrequently but one which may have validity in certain situations, is *reverse*
 8 *trending*. Where application of table factors does not accurately represent market, the factors can
 9 be applied (to original cost) in a reverse sense in order to estimate the historical cost (cost to the
 10 original owner). Then, the appraiser can apply traditional methodology to estimate value. In
 11 order to utilize this approach, an auditor should be assured that the results are indicative of
 12 market value on the lien date.

VEHICLES

14 Vehicles subject to license by the Department of Motor Vehicles (DMV) for on road use *are not*
 15 subject to property tax by the assessor. Property taxes are paid as part of the fee paid to DMV.
 16 However, vehicles not subject to license by DMV *are* subject to assessment by the assessor.
 17 They are considered "implements of Husbandry" or "special vehicles".

18 "Implements of Husbandry" include, but are not limited to, any tool, machine, equipment,
 19 appliance, device or apparatus used in the conduct of agricultural operations, and any additional
 20 items defined by the Vehicle Code.¹⁶⁶ "Special vehicles" include steel-wheeled, track-laying, and
 21 rubber-tired equipment, and other vehicles which are not subject to the license fees by DMV.¹⁶⁷
 22 All of these items are subject to assessment by the assessor because they are not subject to
 23 license fees by DMV, except by special permit. The value should be determined using the same
 24 standards and guides to value applicable to other types of personal property according to section
 25 413. However, in some cases, the assessee of such property may be allowed to deduct from the
 26 amount of property tax any fee paid on such vehicle (i.e., temporary licenses or special permits
 27 including a fee for property tax).¹⁶⁸

28 Other types of property, sometimes used in the ordinary course of business, that are required to
 29 be registered by DMV include truck mounted equipment and relocatable offices. Equipment that
 30 is permanently attached to a licensed vehicle is not subject to local property taxation because it is
 31 considered part of the vehicle. When this equipment is attached to the vehicle the taxpayer is
 32 required to notify DMV in order that the value of the vehicle can be adjusted. It is not assessable
 33 on the county level regardless of whether it is actually assessed by DMV. Similarly owners of
 34 relocatable offices, usually used by construction companies, may register the trailer with
 35 DMV.¹⁶⁹ These trailers are classified as commercial coaches by DMV, and the license can be

¹⁶⁶ Section 411.

¹⁶⁷ Section 994.

¹⁶⁸ Ibid.

¹⁶⁹ The relocatable office may be registered with either DMV, HCD, or may be assessable by the assessor similar to mobile homes.

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verified with the yearly DMV (or HCD) registration. The taxpayer pays an "in lieu fee" for these trailers to DMV, and consequently they are not subject to local property taxation.

EXPENSED EQUIPMENT

Equipment expensed by a taxpayer for accounting purposes is considered taxable personal property as is any personal property used in the ordinary course of business. Expensed equipment may include any type of equipment from small hand tools such as a screw driver to large machinery. This equipment may not be reported on property statements. In the course of an audit, an auditor appraiser should investigate to determine reporting, classification, and assessment of these items. When discovered, all valuation and assessment procedures are the same as used for similar types of property. And again, the owner's treatment of the equipment in the accounting records may provide helpful information, but does not influence assessment.

CONTAINERS

Compressed gas cylinders, beer barrels, and steel drums are examples of types of containers that are typically returned for refill and reuse.¹⁷⁰ A deposit may be required, but there is generally no intention by the buyer to sell the containers but only the product contained within that container. The value of such items is most often determined using the cost approach (cost less depreciation). In some cases, a trade level adjustment may be appropriate. However, the value shall not be less than the deposit or similar charge paid by the buyer.¹⁷¹

ANIMALS AND MIGRATORY LIVESTOCK

Animals and livestock, where classified as personal property and not exempt as business inventory or otherwise, are assessable at full cash value on the lien date in the county where they are located. Taxable animals include those used in riding stables, pack station operations, or rodeos, stallions or broodmares held for breeding, and registered or show horses on the premises which belong to a person other than the property owner. Animals involved in the production of food and fiber, such as dairy cattle and bulls; beef cattle and bulls; draft animals, swine, sheep, and poultry; and animals held for sale or lease on the lien date are exempt from taxation as inventory.

Determining location, or situs, may be difficult due to the constant movement of the "property". It often moves from city to city, county to county, or even state to state. The rules of situs apply. In the case of livestock, location may include more than one county; livestock may graze on land which is on the county line, or the livestock may be physically moved from field to field between counties.¹⁷² Where this occurs in significant proportions, section 990 allows for proration by the assessors' concerned. Section 990 states:

"Where migratory livestock are ranged in two or more counties during the year, the assessors of the counties interested may meet and prorate the number of stock

¹⁷⁰ See Chapter 2 for discussion of situs of containers.

¹⁷¹ Section 996.

¹⁷² For other types of animals, situs should be determined based on the situs rules discussed in Chapter 3, *Situs*.

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to be assessed in each county, taking into consideration the time such stock ranged in each county."

Racehorses are also taxable as personal property. However, valuation is not required. Unlike other types of property, the owner computes and reports the tax due based on section 5722. The statement is then filed directly with the tax collector. See Chapter 7, *Property Statements*, for more information on the assessment of Racehorses.

SPECIAL VALUE ALLOWANCES**Works of Art**

The value of a work of art still owned by the artist who created it that has never been sold nor exhibited for profit, for property tax purposes, is the "full value of the materials which constitute the work of art."¹⁷³

Motion Pictures

The value of motion pictures (including the negatives and prints), for property tax purposes, is "the full value of only the tangible materials upon which such motion pictures are recorded." Section 988 states:

...such full value does not include the value of, or any value based upon, any intangible rights, such as the copyright or the right to reproduce, copy, exhibit or otherwise exploit motion pictures or the negative or prints thereof.

Business Records

The assessment of business records (records of persons engaged in a business or profession) are governed by section 997. The value of this property, for property tax purposes, is "the cash value of only the tangible material upon which, or in which, such records are recorded, maintained, or stored" (section 997). Similar to motion pictures, the value must be "determined without inclusion of or consideration of the intangible value of the information or data so recorded, maintained or stored, nor the intangible right to utilize such information or data."

ONE-WAY PAGING COMPANIES

For the 1996 lien date and thereafter, one-way paging service companies utilizing facilities that are licensed by the Federal Communications Commission (FCC) are assessable by the county assessors. This is due to deregulation of the industry which prompted amendment to section 234 of the Public Utilities Code. Previous to 1996 and this deregulation, these companies were assessed by the State Board of Equalization. Assessors now have jurisdiction over the one-way paging companies; the Board continues to have assessment jurisdiction over the regulated radio telephone companies (i.e., two-way paging companies). Some companies are engaged in both one-way and two-way telephone services; such companies remain under the assessment jurisdiction of the Board.

¹⁷³ Section 986.

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Most often, equipment owned by these companies is valued using the cost approach (Reproduction Cost New Less Depreciation - RCNLD). It is important to have a general knowledge of the equipment to be valued in order to apply appropriate equipment index and percent good factors. Following is a listing of equipment normally applicable and assessable to one-way paging companies. This is equipment that should be reported on the Business Property Statement when applicable to the county, and should be looked for when conducting audits of these types of accounts.

Control and Message Center Equipment

- Radio-telephone control consoles
- Equipment and wiring
- Interconnect equipment, and associated apparatus used in receiving, forwarding, and terminating calls and messages and for other control purposes
- Monitoring and measurement equipment installed for regular control purposes

Fixed Station Equipment

- Transmitters
- Receivers
- Antennas
- Associated equipment and wiring used in base station and repeater operations
- Microwave facilities
- Other equipment used for control of base station operations

Mobile Equipment for One-Way Radio Service, Signaling, or Paging

- Receivers
- Decoders
- Mobile antennas
- Associated apparatus which is mounted in vehicles or is hand portable (*Note: mobile units in stock may be subject to the business inventory exemption.*)

Shop and Test Equipment¹⁷⁴

- Instruments
- Tools
- Other equipment located in offices, shops, or vehicles and used in testing, maintaining, and construction radio-telephone plant.

¹⁷⁴ Note that in many cases, paging companies charge small tools and instruments or other equipment costing \$50 or less directly to operating expense at the time of purchase.

DRAFT**POSSESSORY INTERESTS**

As discussed earlier regarding leases with governmental entities, the Legislature has not defined "taxable possessory interest" as applicable to personal property.¹⁷⁵ Possessory interest is applicable to real property, including property which was formerly personal property but is now classified as fixtures.¹⁷⁶ The value of the taxable *possessory interest* is based on the value of the right to possess or use publicly-owned real property.

When an auditor appraiser encounters leased real property (structure items or fixtures) owned by an exempt public entity, the real property division should be consulted to determine whether a taxable possessory interest exists. The value of this interest is assessable to the lessee on the same basis or percentage of value as other property under section 107.1.

PAWN SHOPS

Property in possession of a pawnbroker, for sale or held for sale (stock not on sales floor) by the pawnbroker, is not assessable to him or her.¹⁷⁷ This is exempt inventory to him/her whether or not the property is owned by him/her unless used in the ordinary course of business.

VALUATION OF AIRCRAFT AND VESSELS

Valuation of aircraft and vessels are unique. Unlike other personal property, this property is normally valued using the comparative sales approach. Sales of similar types of property are usually the best indicators of value. Valuation of both aircraft and vessels are discussed in-depth in separate Assessors' Handbook sections.

¹⁷⁵ *General Dynamics Corp. v. Los Angeles County*, 51 Cal.2d 59.

¹⁷⁶ Section 107.

¹⁷⁷ Section 989.

DRAFT**CHAPTER 7: PROPERTY TAX STATEMENTS**

Property statements are declarations of assessable property signed under penalty of perjury. The property statements filed by taxpayers are used by assessors to gather information and ultimately determine the assessable value of property.¹⁷⁸

The property statement shall show all information as of 12:01 a.m. on the lien date.¹⁷⁹

Except as otherwise specifically provided, all tax liens attach annually as of 12:01 a.m. on the first day of January preceding the fiscal year for which the taxes are levied.¹⁸⁰

The statement shall show "all taxable property owned, claimed, possessed, controlled, or managed by the person filing it and required to be reported thereon."¹⁸¹ The property statement shall also show the situs of the property,¹⁸² and a description of the property in the detail required.¹⁸³

In compliance with section 451, the information on a property statement filed by taxpayers is confidential information. This section reads:

All information requested by the assessor or furnished in the property statement shall be held secret by the assessor. The statement is not a public document and is not open to inspection, except as provided in Section 408.

In general, property statements are similar from county to county. All property statements are prescribed by the State Board of Equalization as set forth under Rule 171, which reads in part:

Except as specifically authorized by the board with respect to heading, name and address of the taxpayer, location of the property, assessor's use columns, and the like, the assessor shall not change, add to, or delete the specific wording of property statement forms or mineral production report forms prescribed by the board or change the sequence of the questions, but he may otherwise arrange the content and alter the size and design of a property statement or mineral production report form to meet the needs of his office procedures and facilities.

Each year, the Board prescribes the property statements that are available for use by assessors for the forthcoming assessment year. The assessor is required to notify the Board of the forms

¹⁷⁸ There are several types of property statements, all prescribed by the Board, based on the type of property: business property, agricultural property, apartments, vessels, aircraft, and etc. For state assessed properties, Property Statements are governed by Part 2, Chapter 4, Article 5 commencing with section 826 through 834.

¹⁷⁹ Section 448.

¹⁸⁰ Section 2192.

¹⁸¹ Section 442.

¹⁸² Section 443.

¹⁸³ Section 445.

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(including exemption claim forms, which are also prescribed by the Board) that will be reproduced using the Board's template, the forms that will not be used, and forms originated by the Board that may have been rearranged by the assessor. Rearranged forms must be submitted to the Board for approval. A checklist provided by the Board accompanies a copy of the forms and instructions submitted to the Board by the assessor.

Assessors commonly develop their own forms to supplement the use of property statements. Such forms or questionnaires may be used in lieu of property statements unless the taxpayer is required by law to file a property statement. For example, section 441 requires that every person who owns taxable personal property (other than a manufactured home) in the county that cost \$100,000 or more must file a property statement. For smaller accounts, the assessor may require the person to file a property statement or may use a questionnaire instead. The key difference between property statements (which must be prescribed by the Board) and questionnaires is that the taxpayer is subject to a 10 percent penalty for failure to file a property statement timely,¹⁸⁴ but the assessor cannot impose (or even threaten to impose) a penalty for failure to respond to a questionnaire. The only exception is that in the case of general aircraft, section 5365 provides that the assessor may ask the owner to file a statement (not Board-prescribed) setting forth the make, model, and year of manufacture of the aircraft, and section 5367 provides for a 10 percent penalty for failure to file the statement timely.

The assessor may request any person within his county to file a property statement.¹⁸⁵ It is, however, much more efficient to request a statement only from those actually owning, possessing, or controlling personal property. An assessor, therefore, should have a program to (1) discover assessable personal property, (2) obtain declarations (or property statements) and (3) process these statements once filed. This chapter will discuss each of these aspects.

DISCOVERING ASSESSABLE PERSONAL PROPERTY

The business climate is ever changing with businesses opening, closing, transferring, and changing locations constantly. (Other types of personal property, vessels and aircraft for example, also exist in ever changing environments.) Therefore, the assessment roll regarding personal property and fixtures must be updated constantly. Developing a program for discovering information regarding taxable personal property and fixtures, and for verifying new and existing information, is the best assurance that the assessment roll is complete, accurate, and valid.

Discovery methods may differ from county to county. These methods may involve procedures tracking property transfers, city business permits, sales tax permits, business questionnaires, telephone and reverse telephone directories, newspapers, Forms 600B and 600R, and Department of Motor Vehicle (DMV) records. It may also include use of field canvassing and field checks.

¹⁸⁴ Section 463

¹⁸⁵ Section 453.

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1 Due to budgetary and time constraints, an assessor may use any or all of these methods
2 depending upon what works best and is most cost effective in that particular county.

Property Transfers

4 If a business or property transfer is processed through escrow, a statement of bulk sale or tax
5 clearance from the county tax collector may be required. These statements contain helpful
6 information regarding the existing business and ownership in addition to information regarding
7 the buyer. If a sale does not go through escrow, information regarding the sale may be provided
8 by the seller. In some situations, to prevent future tax liability, sellers notify the assessor when
9 their business is sold. Whether obtained from the tax collector, the seller, the buyer or another
10 source, the information regarding the sale of a business can be used to update the assessor's
11 inventory of taxpayers who may have taxable personal property or fixtures in the county.

Business Permits

13 If a business operates (or is planning to operate) within city limits, the owner may be required to
14 apply for a business permit. The application normally requests, in addition to other information,
15 the business name, owner's name, business location, and phone number. Therefore, city business
16 permit records can provide a valuable source of information to the counties for property tax
17 purposes. Some cities have monthly summaries of new businesses that they make available to
18 counties. (It is in the city's best interest to aid the county assessor since a portion of collected tax
19 dollars are allocated to them.)

Sales Tax Permits

21 On a monthly basis, the Board of Equalization prepares sales tax permit registration information
22 for counties.¹⁸⁶ This information includes owner and business names, D.B.A. (Doing Business
23 As), address, type of business, and other information pertinent for a business acquiring or
24 updating a sales or use tax permit in the county. The information can be used to update and/or
25 verify business information.

Business Questionnaires

27 Business questionnaires can be a low-cost, yet valuable tool, for following up on other source
28 documents and public records. If data received from other sources does not provide all
29 information required to initiate a new account, or verify information on an existing account, a
30 questionnaire specifically designed by an assessor's business division to request pertinent
31 information may save the time of the field visit (field check).

¹⁸⁶ In the past, this information has been supplied on 3" x 5" cards, but is now also available on computer disc.

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Telephone Directory And Reverse Telephone Directory

A telephone directory or a reverse telephone directory, especially if published near the lien date, can be a useful resource for discovery of businesses. Basic information found here can be used to send business questionnaires or arrange field checks in order to gather enough data to establish or update business accounts.

Newspapers

Useful information concerning business formations, dissolutions, transfers and other changes are found in newspapers. Items referring to newly established businesses or closings are helpful to update the assessment roll. In addition, items regarding new products, or acquisition of a new subsidiary are helpful when establishing an audit list or preparing for an audit.

Valuation Form 600b And 600r

Forms 600B and 600R are forms sent from the Valuation Division of the Board of Equalization to the county assessors. The forms include lists of equipment leased by State-assessed companies that should be locally assessed. State-assessed companies, such as public utilities, are assessed by the Board of Equalization, but the Board may delegate to county assessors the duty to assess property used but not owned by the state assessee.¹⁸⁷

Department Of Motor Vehicles (DMV)

The DMV is a good source for verifying information regarding vessels, special vehicles, or other licensable equipment. Based on the vehicle license number (i.e., CF number for a boat), DMV can provide information such as owner's name, mailing address, location of the property, date of purchase, and purchase price.

Field Canvas

Field canvassing is a technique which involves physically viewing every business location. It is used to confirm current business information in comparison to the assessor's roll, and it can be a reliable technique for discovery. However, the field canvas method of discovery is very time consuming and thus inappropriate for frequent use. Most assessors only use field canvassing periodically to test the validity of the information received from other sources.

Field Checks

A *field check* is a modified version of the field canvas. Instead of visiting every business, an appraiser visits only those where information, or partial information, is already available. For example, field checks can be used as a follow-up on undelivered Business Property Statements and when property statements are not filed for an account in consecutive years.

¹⁸⁷ Article XIII, section 19.

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Valuable information may be discovered when the auditor appraiser is physically at the business location. In addition to obtaining information regarding the owner, the auditor appraiser can secure data necessary to estimate the value of the business property. Such data, and the value estimate, becomes essential if the taxpayer does not file the Business Property Statement.

Other Sources of Information

Other sources of information that are available to assessors for the discovery of new businesses include, but are not limited to: change in ownership, building permits, certificates of occupancy, health permits, and business web sites. Each may provide valuable information which is necessary to make a valid assessment. Discovery methods differ from county to county and each county should determine the most effective means of discovering new businesses and updating information on existing businesses.

OBTAINING STATEMENTS**FILING REQUIREMENTS**

Some taxpayers are required to file property statements. Others are required to file only upon request of the assessor. Section 441 identifies the requirements, in part, as follows:

Each person owning taxable personal property, other than a mobilehome subject to Part 13 (commencing with Section 5800), having an aggregate cost of one hundred thousand dollars (\$100,000) or more for any assessment year shall file a signed property statement with the assessor. Every person owning personal property which does not require the filing of a property statement or real property shall upon request of the assessor file a signed property statement. Failure of the assessor to request or secure the property statement does not render any assessment invalid.

When the county assessor mails or otherwise provides a property statement to a taxpayer, the assessor has thereby requested the taxpayer to file. These statements must then be filed timely and signed under penalty of perjury by the deadline as prescribed under section 441. In general, the deadline is the last Friday in May, each year, or a date determined by the assessor (but no earlier than April 1). (If an assessor designates a filing date other than the last Friday in May, a late penalty cannot be imposed unless certain requirements are met by the assessor as described in section 441.)

If the taxpayer does not file the property statement by the deadline, the assessor shall estimate a value and add a 10 percent penalty to that estimated assessed value.¹⁸⁸ For existing businesses, this value might be the value from the previous roll year. For new businesses, this value may be estimated by the appraiser based on similar businesses or based on the initial information received when the business was originally added to the assessment roll. No matter what method

¹⁸⁸ Section 501 and section 463

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1 is used to estimate the current roll value, it should be a reasonable estimate of market value based
 2 on available information.¹⁸⁹

3 When a property statement is filed timely in duplicate (on or before the prescribed deadline), the
 4 taxpayer may request the assessor to provide the full value computed by the assessor for each
 5 category (supplies, equipment, etc.). Under section 443.1, the assessor has the obligation to
 6 comply. Further, the assessor is required to return the duplicate, with the full value for each
 7 category, to the taxpayer by July 15th of the year in which the statement was filed.

DIRECT BILLING

8
 9 For smaller businesses and other selected accounts, assessors may use direct billing.¹⁹⁰ Direct
 10 billing systems select accounts to appraise periodically, normally once every three years, in lieu
 11 of annual property statements. When the total (personal property and fixture) value of a business
 12 changes very little from year to year, direct billing can have a number of advantages over
 13 annually sending a property statement. The advantages for both the assessor and the property
 14 owner are efficiency and cost savings. The process (1) reduces the number of property
 15 statements mailed out, received, and processed each year, thus reducing administrative costs, and
 16 (2) deletes the filing requirement for the taxpayer (unless material changes are made to taxable
 17 property in that year).

18 Accounts appropriate for direct billing are usually established (older) businesses, having tangible
 19 personal property costing less than \$100,000, and minor changes in equipment holdings from
 20 year to year. Small barber shops and small retail stores with minimal equipment holdings are
 21 good examples. The total personal property and fixture value of these businesses usually does
 22 not change much annually.

23 Many accounts are not appropriate for direct billing. Direct billing cannot, for example, be used
 24 for accounts whose tangible personal property cost is \$100,000 or more, since these accounts are
 25 required to file in accordance with section 441. New businesses, no matter what the value,
 26 should not be put on direct billing. New businesses tend to acquire equipment more often than
 27 do older businesses of similar type. Even if a new business seems to fit the description of a
 28 business that could appropriately be put onto the direct billing system, the assessor may wish to
 29 have property statements for the first year(s) in the business file. These property statements
 30 would establish a starting point for determining a valid assessment and confirm that the account
 31 is a good candidate for direct billing due to little or no change in property acquisitions or
 32 disposals.

¹⁸⁹ Section 501.

¹⁹⁰ Direct billing is not mandated or even discussed in the statutes. Direct billing is a system of assessment developed by the counties. Taxpayers cannot be required to participate in a direct billing system. In addition, the assessor is not precluded from processing roll corrections if applicable.

DRAFT**PROCESSING STATEMENTS****PRELIMINARY REVIEW: REQUIRED INFORMATION**

Upon receipt of a property statement, the statement should be logged as received and verified as complete. If the statement is not complete, an accurate assessment cannot be accomplished. The guidelines used in the determination of a complete property statement are identified in the statutes and are discussed below.

To verify completeness pursuant to these sections, and to aid in processing a statement, it may be helpful to use a checklist. An example of a property statement checklist is found later in this chapter.

Contents Of Statement

The property statement shall show all taxable property owned, claimed, possessed, controlled, or managed by the person filing it and required to be reported thereon.¹⁹¹ The property statement is made up of several sections, titled "parts" in addition to Schedule A and Schedule B. Each section requests information necessary for a valid assessment. It is important to review each section of the statement for possible errors.

Situs

A valid assessment requires a specific location; property must be assessed in the appropriate county, city, and district. Therefore, the property statement shall also show: (a) the county where the property is taxable and (b) if taxable in the county where the statement is made, any city or revenue district where it is situated.¹⁹² This, generally, requires the taxpayer to report the physical address of the property or the assessor's parcel number on which it is located. The statement is not complete if the location of the property, as specified in section 443, is not shown.

It is not only important to verify that the situs of the property is reported, but that the property is reported to the appropriate county. It is not uncommon for a taxpayer, owning several business at various locations in California, to file a statement with the wrong county. At times, erroneous assessment(s) can be avoided simply by reviewing the reported situs on the property statement. (Other times, however, situs errors may not be identified until an audit is conducted.)

Description Of Property

The property statement shall show a description of property, in the detail required.¹⁹³ Such detail shall include the cost of the property, if the information is within the knowledge of the assessee or is available from their own or other records, and the classification of the equipment (the physical description).¹⁹⁴ The property statement instructs the taxpayer to report the equipment by

¹⁹¹ Section 442.

¹⁹² Section 443. Each city or district may have different tax rates within the jurisdiction.

¹⁹³ Section 445.

¹⁹⁴ As noted earlier the statement is signed under penalty of perjury. Therefore, unless additional information indicates otherwise, it must be assumed that the taxpayer classified the property accurately.

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category (machinery and equipment, office equipment, computer equipment, etc.) year of acquisition, and cost. Further description (other than total cost by year and classification) is required for reported additions and deletions of improvements and construction in progress.

It is important to determine whether the property is properly described in order to make an accurate assessment. Some statements, for example, are received with the total cost reported on the front sheet, but without costs classified or reported by year of acquisition on Schedule A. Others are received with a valid signature but no costs reported anywhere on the form (or with a statement "same as last year"). Still other statements may be filed with costs which appear inappropriate (i.e., the rendition does not resemble the costs that were reported in the previous year). Review of property statements filed in previous years or a phone call to the taxpayer, or both, may clear up some discrepancies or inconsistencies in the current property statement. In some cases it is necessary to mail the statement back to the taxpayer to request that the omitted information be submitted. (It may be advisable for the assessor to keep a copy of the statement prior to sending the statement back.) In these situations, the statement is not considered filed by the taxpayer unless the deficiencies are corrected and the complete statement is returned prior to the filing deadline.

Tax Day

As previously noted, a property statement shall show all information as of 12:01 a.m. on the *lien date*.¹⁹⁵ The lien date, pursuant to section 2192 and 722, is January 1.¹⁹⁶

It is important to remind taxpayers that an assessment is based on information (as reported on the property statement) and value of property owned on the preceding lien date, although a tax bill is not received until either July or November of that same year. A taxpayer filing a 1998 property statement (which declares property owned as of 12:01 a.m. January 1, 1998), for example, will receive a tax bill for:

- **an unsecured account** by mid July 1998 for the fiscal year July 1, 1998 - June 30, 1999.¹⁹⁷
- **a secured account** in November 1998 for the fiscal year July 1, 1998 - June 30, 1999.

The tax bills, in both cases, reflect property reported on 1998 property statements as of the lien date, January 1, 1998; the cost of all taxable property acquired and owned or controlled as of or through December 31, 1997. Sale or disposal of the personal property (business property, vessels, and aircraft) between the lien date and start of the fiscal year does not relieve the taxpayer of any tax liability¹⁹⁸ unless the assessment is secured and the new real property owner does not own, claim, possess, or control the personal property at any time between the lien date

¹⁹⁵ Section 448.

¹⁹⁶ Prior to January 1, 1997, the lien date was 12:01 a.m. March 1 pursuant to these sections.

¹⁹⁷ Unsecured taxes are due on January 1, so some counties mail the unsecured tax bills as soon as the assessments are prepared.

¹⁹⁸ See Example 1.1.

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and the date the assessment was made.¹⁹⁹ Personal property taxes are not pro rated and are assessed to the owner on the lien date.

Authorized Signature

Property statements and mineral production report forms prescribed by the Board, and filed with the assessor or the Board, must be signed by the assessee, a partner, a duly appointed fiduciary, or an agent.²⁰⁰ Statements filed on behalf of a corporate assessee must be signed by an officer or by an employee or agent for whom the board of directors has submitted written authorization to sign on behalf of the corporation. When signed by an agent who is not a member of the bar, a certified public accountant, a public accountant, an enrolled agent, or a duly appointed fiduciary, then the assessee must authorize appointed agents by filing a statement with the assessor's office.

A property statement that is unsigned, or signed by an unauthorized agent, does not constitute a valid filing.²⁰¹ Such a statement is incomplete and invalid, and should be returned to the taxpayer. (It may be advisable to keep a copy of the statement prior to sending the statement back.)

SPECIFIC SECTIONS OF THE PROPERTY STATEMENT

When it is concluded that a property statement is complete, it is a valid filing. The next phase is reviewing the reported information and processing the data into an estimate of value. The appraiser should initially review sections on the form that may require extra attention or where the taxpayer needs to be contacted for additional information or clarification. For example, costs reported as construction in progress and costs reported on Schedule B usually require review and coordination by both a real property appraiser and auditor property appraiser. If the itemized and detailed descriptions of these costs are missing from the filing, the taxpayer may need to be contacted.

Besides reviewing specific areas that may require special attention or follow up work, it is also important to focus on the statement in whole. That is, does the total reported cost for this type of business seem appropriate? Review (and processing) of specific parts of the property statements are discussed below. The Business Property Statement is used as an example, although there are other statements filed with the business division of the assessor's office.²⁰² In all cases the statements are requesting data on the owner, location, and cost of the property.

¹⁹⁹ Section 2189 provides that in such a case the assessment of the personal property must be transferred to the unsecured roll.

²⁰⁰ Rule 172.

²⁰¹ Rule 172

²⁰² A sample of a Business Property Statement is included in the appendix for reference purposes.

DRAFT**Part I: General Information**

This section of the property statement provides general information on the business and indicates (a) the type of business, (b) the telephone number, (c) if the taxpayer owns the realty where the business is located, (d) when the business started at this location, (e) confirms the business location, (f) where the records are located, (g) if a change in ownership or control has occurred during the last fiscal year, and (h) if the company or business has any related business entities in the county.

(a) **Type of business:** Business type (retail, manufacturing, service, etc.) is information useful when applying appropriate valuation factors and for gauging whether the reported costs appear reasonable for that type of business.

(b) **Telephone number:** The phone number provides a convenient way to contact the taxpayer in the event questions arise during the review and processing of the statement.

(c) **Owner of realty:** Business personal property can be secured to realty if in fact the owners of the personal property and the real property are one in the same. It is, therefore, important to determine the ownership of the realty where the business is located. Business personal property held by a corporation, for example, cannot be secured to real property held in the name of an individual.

(d) **Date business started at current location:** It is important to know when the business started at the current business location in order to verify the initial assessment year.

(e) **Business location:** The business location, or situs of property, indicates whether the business is physically located in the county and it is used to designate the appropriate tax rate area.

(f) **Location of records:** If an audit is required or needed, the audit is normally conducted at the location of the records (which may or may not be at the business location within the county).

(g) **Change in ownership or control during the last fiscal year:** A change in ownership of the real property or a change in control of the partnership, corporation or legal entity owning the property is important information that must be conveyed to the real property division. An appraiser should also note how this section is completed because it may affect the costs reported in Part II of the statement.

(h) **Related business entities in the county:** If the taxpayer owns other businesses in the county, all the assessments of personal property and fixtures must be accumulated to determine whether the business is subject to mandatory audit. It could also be a source of information in the discovery of new businesses, and other related businesses.

DRAFT**Part II: Declaration Of Property Belonging To You**

This is the section of the statement where the taxpayer reports property owned by the business. The property is reported by type including (a) supplies, (b) equipment, (c) equipment out on lease or rent to others, (d) buildings, building improvements, and/or leasehold improvements, land improvements, land and land development, and (e) construction in progress.

With the exception of supplies and construction in progress (discussed below), property reported by the taxpayer should be classified and reported by year of acquisition. The statement gives instructions to the taxpayer on classification of the property and applicable costs to be included in the reported cost of the property. However, the taxpayer is not required to value the property.²⁰³

Valuation is conducted by the assessor's office.²⁰⁴

Supplies

Supplies is a category of personal property that is frequently not reported, although the majority of taxpayers have at least minimal taxable supplies. Many times the cost is low and it is simply forgotten by the taxpayer. In reviewing the statement, an auditor appraiser should check the reported supplies figure. Is a supplies cost reported? If so, is it appropriate for that type of business? If not, what should it be?

Below is an example of supplies reported on a Business Property Statement.

Example 7.1: Supply Cost Reported on the Business Property Statement
<p>The owner of a small video rental store reports \$11,500 of supplies, \$15,000 of equipment, and \$5,000 of leasehold improvements.</p> <p>Does the reported supplies cost appear reasonable (in terms of quantity, cost, and type) in relationship to the size, location, and typical operation of a video store?</p> <p>No. The reported supplies cost does not appear reasonable based on a "typical" video store. It appears that the taxpayer either misclassified property, or reported property that is considered business inventory for property tax purposes. The taxpayer may have reported the total cost of the movies in the rental stock. If so, supplies is overreported. Only the movies out on rent on the lien date are reportable and assessable. The movies "held for rent" are exempt inventory. The appraiser should contact the taxpayer to clarify what cost items are included in the \$11,500 cost reported as supplies on the property statement.</p>

As shown in the example above, it is important to review reported supplies for reasonableness and contact the taxpayer or other sources for more information if necessary.

²⁰³ *Clunie v. Siebe*, (1896) 112 Cal. 593.

²⁰⁴ Classification and valuation are discussed in other chapters of this manual.

DRAFT**Construction-In-Progress (CIP)**

The instructions require the taxpayer to attach a schedule supporting CIP reported on the property statement. This schedule should identify all of the costs which make-up the reported CIP total. Using this schedule, the costs can be classified; the total may include costs that are not assessable, and/or costs which should be allocated between the secured or real property assessment and the personal property assessment. It is important to coordinate the classification and assessment of these items with a real property appraiser to avoid duplicate or under assessment.

Proper Classification of Fixture and Structure Items (Schedule B)

Schedule B includes four categories of improvements: structure items only, fixtures only, land improvements, and land and land development.²⁰⁵ As in the case of construction-in-progress, these costs should be reviewed to avoid erroneous assessments. Not only should proper classification be verified (i.e., reported in the appropriate column?), but coordination between the real property appraiser and the auditor appraiser must take place to ensure that an accurate and valid assessment is made. Chapter 5 of this manual provides a discussion on the classification and valuation of improvements related to a business property.

Part III: Declaration of Property Belonging to Others

Part III, *Declaration of Property Belonging to Others*, on the Business Property Statement applies to equipment that may be assessable to a taxpayer other than the one filing the statement. As discussed in Chapter 6, title to the property may be held by a party other than the one who files the statement and it may be assessable to that other party.

Equipment reported in this section is reported by type: leased equipment, lease-purchase option equipment, capitalized leased equipment, vending equipment, other businesses, and government-owned property. They are also reported by tax obligation: lessor or lessee. Each lease should be cross referenced with renditions received from the lessors to avoid duplicate assessments or escaped assessments, and to ensure accurate assessment of the equipment. For example, the taxpayer (lessee) may classify a lease as a capitalized lease assessable to the lessee. Referencing the statement received from the lessor indicates it is a true lease assessable to the lessor. Reconciling these differences prior to assessment, and close of the roll, will help to avoid subsequent roll changes.

Cross-referencing may involve an additional step when there are changes in ownership: e.g., when one leasing company buys the portfolio of another or when a lessee experiences an ownership or name change. The lessee(s) may continue to reference the former company in Part III of their statement; the lessor may continue to reference the former lessee's name in their reporting. In such cases, the assessor's system of cross-referencing is extremely important to minimize erroneous, duplicate, and escape assessments.

²⁰⁵ For thorough discussion of classification, see Chapter 2 *Classification* and Chapter 5, *Assessment of Improvements Related to Business Property*.

DRAFT**1 INCONSISTENT REPORTING**

2 Sometimes costs reported on property statements are not consistent with costs reported in
3 previous years. Differences may be due to equipment transfers or dispositions within the last
4 year, a buyout of previously leased equipment, or simply misreporting. Differences, particularly
5 changes other than dispositions, should be researched and analyzed as much as possible prior to
6 enrolling an assessed value.

7 When it is found that inconsistencies affect past assessment years, roll changes may be necessary.
8 In most instances, these roll changes will be done at the close of the current year's roll. These
9 changes are discussed further in Chapter 9, *Roll Procedures*.

10 REVIEW OF PREVIOUS AUDIT FINDINGS

11 When an audit is conducted it is important to use the audited costs, or incorporate audit findings
12 as appropriate, in subsequent years when a property statement is processed. Although a property
13 statement as filed may reflect costs as reported in the previous year, rather than recommendations
14 made through the audit, an appraiser should make an effort to identify and correct problems prior
15 to enrollment.

16 PROPERTY STATEMENT CHECKLIST

17 Following is a sample *property statement checklist* that may be used to verify completeness of a
18 property statement. The checklist also provides a summary of the information discussed in this
19 section.

DRAFT**Table 7A: Property Statement Checklist**

- Log property statement as received.
- Check signature, if not authorized signature property statement not valid (some counties retain a copy prior to returning original for signature).
- Check statement for any changes to situs, mailing address, and/or business name; make any necessary changes.
- Check for any change of ownership regarding business and/or real property. Make any necessary changes (e.g., notify the real property division, make changes to unsecured account).
- Confirm that account is appropriately classified as secured or unsecured (review responses to Part I: General Information questions).
- Confirm that property is reported and described as required.

Are costs summarized on the front of the form classified and broken down by year of acquisition on schedules A and B?

Does the statement include a description of costs reported as construction in progress, and costs added to or deleted from Schedule B?

- Did the taxpayer report supplies? If yes, does the reported cost seem reasonable. If not, estimate supplies on hand on lien date.
- Did the taxpayer report leased equipment? If yes, cross reference to lessor files to confirm reported information and to prevent duplicate assessment or escaped assessments.
- Check current reported costs with costs reported in previous years. Is it consistent? If not, a phone call to the taxpayer may be required.
- Are CIP (construction in progress) costs reported? If yes, reference description of costs provided by taxpayer and coordinate assessment with real property appraiser.
- Are CIP costs from the previous year accounted for on the current year's property statement?
- Are additions (or deletions) reported on Schedule B, *Buildings, Building Improvements, and/or Leasehold Improvements, Land Improvements, Land and Land Development*? If yes, reference description of additions/deletions provided by taxpayer and coordinate assessment with real property appraiser.

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DRAFT**1 VALUATION**

2 Finally, after the property statement has been reviewed and is considered complete, the auditor
3 appraiser must value the taxable property reported on the statement. As discussed earlier, in
4 most cases, this involves using the cost approach to value and the application of equipment index
5 factors and percent good factors. Sound appraisal judgment is required to determine which
6 factors apply in each situation. For new accounts, reviewing the factors adopted by the assessor's
7 business division and reviewing lives given to the equipment used by similar businesses will help
8 with this process. For older or existing accounts, and statements that show little or no change
9 from previous assessment years, the same table and economic life estimate as previously
10 assigned are usually appropriate. Referring to the previous years property statement
11 electronically or in the physical file will verify the factors used. Additionally, refer to equipment
12 index and percent good factors included in Assessors' Handbook Section 581, *Equipment and*
13 *Percent Good Factors*.

14 In some cases, as the result of physical inspections, audits, assessment appeals, income approach
15 estimates, sales data, or other data gathered in prior years, the assessor's office has agreed that the
16 standard cost approach is not appropriate for specific accounts. The agreed-upon approach
17 should be reviewed and used, when appropriate, in subsequent years. This will avoid the same
18 problem occurring year after year.

19 LATE FILINGS AND NON-FILINGS

20 If the property statement is filed late, a 10 percent penalty is applied to the assessed value of the
21 unreported property. In part, section 463 reads:

22 If any person who is required by law or is requested by the assessor to make an
23 annual property statement fails to file it with the assessor by 5 p.m. on the last
24 Friday in May, or if, after written request by the assessor, any person fails to file
25 an annual property statement within the time limit specified by Section 441 or
26 make and subscribe the affidavit respecting his name and place of residence, a
27 penalty of 10 percent of the assessed value of the unreported taxable tangible
28 property of such person placed on the current roll shall be added to the assessment
29 made on the current roll.

30 In the case of late filings, the 10 percent penalty is added to the value computed using the
31 reported costs on the property statement filed late. If a statement is not filed, the 10 percent
32 penalty is applied to the auditor appraiser's best estimate of value based on other information
33 available.

34 Verification of Existing Business

35 If a statement is not filed for one or more years (time period at the discretion of the assessor),
36 existence of the business should be verified. Verification may be accomplished with a phone call
37 or a field check of the business. If the verification process indicates that the business is no longer
38 in operation, the next step is to confirm when the business ceased operation to prevent any

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erroneous assessments. Confirmation of the closing date can be accomplished by contacting the subject business owner (if possible), landlord, neighboring tenants, or the current tenant of the same location.

PROCESSING CLOSE-OUTS

Information regarding business close-outs may come from any one of the sources indicated earlier, or from the business owner who uses the property statement to notify the assessor that the business is no longer in operation in the county. This is also an opportunity to identify new businesses. Is a new business at the site, or is the site vacant?

LOW VALUE PROPERTY (LOW VALUE ORDINANCE)

When a property statement is processed, resulting in (1) personal property with a value so low that, if not exempt, the total taxes special assessments and applicable subventions on the property would amount to less than the cost of assessing and collecting them and/or (2) real property/fixtures base year value or full value of \$5000 or less, the assessment may be exempt if authorized by the county board of supervisors. Pursuant to section 115.2, *Exemption of property having a low value*, the board of supervisors may adopt an ordinance implementing these low value provisions in that county. Most counties have enacted a low value ordinance (section 155.2) using various minimum values. Others have not enacted the ordinance at all, and therefore have no value minimum.

PROPERTY STATEMENTS FOR SPECIAL TYPES OF PROPERTY

Other property statements that are filed and processed in the business division of an assessor's office include agricultural, apartment, aircraft, and vessel property statements. One type of property statement, the racehorse property statement, is filed with the tax collector. The format of the forms are different, the type of property that is reported is different, but the purpose of the forms are the same. The forms are filed by the taxpayer, and signed under penalty of perjury, and used by the assessor (or the tax collector) to determine the assessable value (and/or tax) of the property located in the county on the lien date.

The steps in processing the agricultural and apartment statements are similar to the processing of the business return. Thus, a discussion of each individual statement will not be included here. The aircraft, vessel, and racehorse property statements, however, are unique and require mention.

Aircraft

Section 5365 specifically discusses the aircraft statement. "Upon request of the assessor of the county in which an aircraft is habitually based, the owner shall file with him a statement setting forth the make, model and year of manufacture of the aircraft." As previously discussed, this is the one statement that is not Board-prescribed but a penalty is applicable if the owner does not return the statement timely.

In addition, section 5366 requires airport owners and/or operators to file statements reporting aircraft located at their airports. This section of the code, in part, states:

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Owners, as well as operators, of private and public airports shall, within 15 days following the lien date of each year, provide the assessor of the county in which the airport is situated with a statement containing a list of names and addresses of the owners, and the make, model, and aircraft registration number, of all aircraft which were using the airport as a base.

For the most part, the discovery of aircraft located in a county is through the statements filed by the airport owners and/or operators. After the discovery of an aircraft (in a particular) county, an account is established by the assessor's office and an aircraft statement is mailed to the owner of the aircraft. Two basic sets of forms are used for the assessment of aircraft; one is designed by the assessor for the assessment of general aircraft, and several Board-prescribed statements are designed for certificated aircraft. Specific statutes exist for each type. Thorough discussions of aircraft assessment are contained in Assessors' Handbook Section 570 (AH 570), *Commercial Aircraft Value Allocation*, and Assessors' Handbook Section 577 (AH 577), *Assessment of General Aircraft*. A discussion on situs of aircraft is included in Chapter 3, *Situs*, of this manual.

Vessels

The requirements set forth in section 441, *Property statement; other information*, also apply to property statements filed for vessels. A standard property statement used for all types of vessels includes questions that require the taxpayer to describe the vessel in a manner sufficient for an accurate assessment. Similar to other types of personal property, vessels are assessed at market value each year. The information received from the taxpayer on the vessel property statement identifies the vessel type, the cost, the age, and the size, and it significantly aids in the valuation of the property. Most assessors use questionnaires in lieu of property statements for smaller vessels (less than \$100,000 cost).

Methods of discovering vessels located in the county on the lien date include records from the DMV, marina listings, and listings from other types of boat storage facilities. Registration information is received monthly from DMV regarding (1) vessels moved in and out of the county, and (2) sales of new or used boats to taxpayers that claim situs in the county. Operators of marinas and boat storage facilities file annually, with the assessor, listings of boats located at their facilities on the lien date. For further information on vessels see Chapter 3 of this manual (situs of vessels) and Assessors' Handbook Section 576 (AH 576), *Assessment of Vessels*.

Racehorses

As mentioned earlier, property statements for and taxation of racehorses are unique and are treated differently than are other types of personal property.²⁰⁶ Most significantly, as provided in section 5782, property statements (provided by the assessor) are filed with the tax collector's office rather than the assessor. No valuation is required by the assessor because the taxpayer reports an annual tax due based on a schedule in the statute.²⁰⁷ The lien date regarding the assessment of racehorse is the same as other types of personal property, January 1, but unlike

²⁰⁶ The taxation of racehorses is discussed in sections 5701 through 5790 (Part 12) and Rules 1045 through 1047.

²⁰⁷ Section 5722.

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- 1 other types of property, the tax becomes delinquent at 5 p.m. February 15 of the same calendar
- 2 year.²⁰⁸

²⁰⁸ Section 5762.

DRAFT**CHAPTER 8: PROPERTY TAX AUDITS****AUDIT OBJECTIVE**

A property tax *audit* is a means of collecting data relevant to the determination of taxability, situs, and value of property.²⁰⁹ It is used to verify a taxpayer's reported cost and other information which may influence the assessment of all items that are taxable under property tax law. An *audit program* is a system used to select and conduct these audits. Both are used to sample property tax assessments to ensure that taxable property and related information have been reported accurately by the taxpayer and have been assessed properly by the assessor.

The scope of a property tax audit (for local assessment) is more limited than other types of tax or financial audits, whether internal or external, in that it usually focuses on the financial position of a business as related solely to fixed assets. The primary objective is to confirm that taxable property is being assessed properly and uniformly. Although most taxpayers report their taxable property in good faith, errors do occur on the part of both the taxpayer and the assessor. Audits, and the audit program as a whole, help to identify problems, correct inaccurate existing assessments, and increase the likelihood that future assessments will be accurate through improved reporting by the taxpayer and improved understanding of the property by the assessor's office.

The purpose of this chapter is to provide helpful information regarding the audit procedures employed by auditor appraisers, thereby improving the post-audit program and assessments made to business personal property and fixtures. An auditor appraiser's experience, training, and good judgment are not meant to be replaced. The discussion should assist in making an audit complete and accurate, and/or aid the assessor in the development or improvement of their own auditing procedures and manuals.

STATUTORY PROVISIONS

Statutes not only authorize the assessor to conduct audits, but require audits in certain circumstances. Section 441(d), sections 469, 470, and Rules 191, 192 and 193 provide the assessor with the basic statutory authority to review a taxpayer's records. For taxpayers owning or possessing tangible business personal property and fixtures with a full cash value of \$300,000 or more, section 469 *requires* an audit at least once in each four-year period.

When an auditor contacts a taxpayer, to make an audit appointment for any type of audit, the taxpayer may question the auditor's authority and may be reluctant to provide records. An auditor should assure the taxpayer that the audit is:

- routine (i.e., certain audits are mandated under section 469);

²⁰⁹ Rule 191.

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- beneficial (i.e., an audit is a taxpayer's best opportunity to verify the accuracy of past assessments);
- helpful (i.e., the audit results will be made available to the taxpayer);
- corrective (i.e., if the results indicate an overassessment, the taxpayer may be entitled to a cancellation of tax or the right to file a claim a refund), and
- fair (i.e., if the results indicate an underassessment, the taxpayer has the right to file an appeal on the escape assessment).

It is also helpful to inform the taxpayer of any relevant statutory provisions authorizing audits under the Revenue and Taxation Code.

Section 441(d) states:

At any time, as required by the assessor for assessment purposes, every person *shall make available* for examination information or records regarding his or her property or any other personal property located on premises he or she owns or controls.... (Italics added.)

Section 470 states:

Upon request of an assessor, a person owning, claiming, possessing or controlling property subject to local assessment *shall make available*...a true copy of business records relevant to the amount, cost, and value of all property that he or she owns, claims, possesses, or controls within the county. (Italics added.)

And section 469, as quoted earlier, requires audit by stating:

...a taxpayer engaged in a profession, trade, or business has a full value of three hundred thousand dollars (\$300,000) or more, the assessor *shall audit* the books and records of that profession, trade, or business at least once each four years.... (Italics added.)

Many taxpayers and/or their agents are especially reluctant to show an auditor copies of income tax returns. The auditor can further cite section 462 which provides:

Every person is guilty of a misdemeanor who, after written request of the assessor does any of the following:

(a) Refuses to *make available* to the assessor any information which is required by Section 441(d).... (Italics added.)

The auditor can also refer the taxpayer to the case of *Lyons v. Estes* (1969) 6 Cal.App.3d 979, where the court upheld legislative history and these sections. The court specifically stated that the

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1 county assessor is a tax official, as defined by the Revenue and Taxation Code, who may
2 inspect income tax returns to assist him/her in assessing property.

3 In extreme cases, where a taxpayer cannot be persuaded to make records available, records may
4 be subpoenaed. Sections 468 and 454 provides the assessor the power to subpoena. Section 468,
5 *Failure to furnish information; assessor's remedy*, authorizes the assessor to apply to the superior
6 court to order the person to appear before the court. Section 454, *Examinations*, states that the
7 assessor may subpoena and examine any person in relation to assessable personal property and
8 fixtures in his or her county.

9 Alternatively, the assessor is authorized to estimate the value of the property. If, after written
10 request, any person has failed to comply with the requirements to furnish information on the
11 property statement under section 441 or pursuant to audit under section 470, the assessor is
12 authorized to estimate value based on the information in his/her possession.²¹⁰

13 Following is a summary of Revenue and Taxation Code sections and Property Tax Rules related
14 to audits, concerning both the taxpayer's and assessor's rights and responsibilities. These
15 sections will also be discussed in the remainder of the chapter.

²¹⁰ Section 501.

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Table 8A: Summary of Revenue & Taxation Code Sections Related to Audits	
R&T REFERENCE	REMARKS
Section 408	<u>Assessor's Records.</u> The assessor shall, upon request, permit the assessee or assessee's designated representative to inspect or copy all documents, including but not limited to audit narratives and work papers, relative to the appraisal and assessment of the assessee's property.
Section 441(d)	<u>Property statement; other information.</u> A taxpayer shall make records available upon assessor request.
Section 454	<u>Examinations.</u> The assessor may subpoena and examine a person regarding any statement furnished him, or any statement disclosing property stored, possessed, or controlled by that person.
Section 462	<u>Refusal to give information.</u> A person is guilty of a misdemeanor who refuses to make information available as required by section 441(d).
Section 468	<u>Failure to furnish information; assessor's remedy.</u> If a person fails to furnish requested information, the assessor has the power to subpoena that information.
Section 469	<u>Audit of profession, trade, or business.</u> (Mandatory Audit) A profession, trade, or business which has a full value (personal property and fixtures) of \$300,000 or more shall be audited at least once every 4 years. (See also Rule 191, 192, and 193.) If the audit results in a change to a previously enrolled assessment, the assessor shall provide the assessor's findings in writing and all property at that location that has not been previously equalized is subject to appeal.
Section 470	<u>Business Records.</u> A taxpayer shall make records available, upon assessor request, at their principle place of business or at a mutually agreeable place. The taxpayer may pay the county the reasonable and ordinary expenses incurred if located outside California. Authorizes nonmandatory audits.
Section 501	<u>Failure to furnish information .</u> If after written request by the assessor, any person fails to comply with sections 441 and/or 470 (i.e., provide information), the assessor shall estimate value based on the information available.
Section 532	<u>Statute of Limitations.</u> Six year statute of limitations where 25% penalty applied. Four year statute of limitations where no penalty, or the 10% penalty, applies.
Section 532.1	<u>Extension of time for making escape assessment.</u> Extends the time period specified in section 532 for making an escape assessment.

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Table 8A: Summary of Revenue & Taxation Code Sections Related to Audits	
R&T REFERENCE	REMARKS
Rule 191	<u>Property Tax Audits, General.</u> Defines the purpose of an audit in general and gives requirements regarding notification of findings to taxpayers and taxpayers rights following an audit.
Rule 192	<u>Mandatory Audits.</u> Defines Mandatory Audit. See also section 469. (Rule 192(e) also refers to nonmandatory audits. See also section 470.)
Rule 193	<u>Scope of Audit.</u> Rule 193(a) authorizes "sampling" of one year within the four-year audit period. Rule 193(b) discusses use of audit findings resulting from a Board assessment practices survey.

DRAFT**GENERALLY ACCEPTED STANDARDS**

Property tax audits must be conducted in a professional manner. The auditors are called upon to exercise their highest skill and most impartial judgments throughout the performance of their official duties. To assure that audit methods and techniques are appropriate to the specific assignment, sound professional judgment must be exercised in developing procedures and conducting tests that meet the scope to achieve the audit objectives.

The primary objective of the property tax audit is to determine (with the least possible expenditure of time) the correct assessment to be made. The auditor, therefore, must apply generally accepted auditing standards and utilize generally accepted accounting principles, *and* appraisal principles. In certain circumstances, these sets of principles sometimes conflict (such as when the trade level concept applies). Under such circumstances, the auditor may need to supplement application of generally accepted accounting principles and generally accepted auditing standards with sound appraisal principles to arrive at a correct assessment as required by law. Since this audit is being done for property tax purposes, appraisal principles may take precedence.

Following are standards set forth by the American Institute of Certified Public Accountants (AICPA) as applied to the property tax auditor. These standards should guide the auditor in all audit situations.

GENERAL STANDARDS

1. An auditor should have adequate technical training and proficiency as an auditor (and as an appraiser).²¹¹
2. In all matters relating to an assignment, an independence in mental attitude should be maintained by the auditor.
3. Due professional care should be exercised in the performance of the examination, in the preparation of the report, and in the maintenance of confidentiality.

²¹¹ This standard, as set forth by the AICPA, did not refer to appraisers. It has been applied to the property tax auditor appraiser. Certification as appraiser and auditor must be maintained pursuant to section 670 and section 671 of the Revenue and Taxation Code.

DRAFT**STANDARDS OF FIELD WORK**

1. The work should be adequately planned, and supervised as appropriate.
2. There should be a proper evaluation of existing internal controls as a basis for reliance. This will determine and restrict the auditing procedures.
3. Sufficient competent evidential matter should be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination.

AUDIT SELECTION

An important part of the audit program is the selection of accounts to be audited. As discussed earlier, some audits are required by law (*mandatory*) while additional audits (commonly referred to as *nonmandatory*) can be selected by the assessor as a means of sampling the system as a whole. Each can be conducted in a variety of ways. Several categories of audits and means for conducting audits are discussed briefly in the following section.

TYPES OF AUDITS**Mandatory Audits**

Audits required by law, *mandatory audits*, are the most important for an auditor to complete in a timely manner. As required by section 469 and Rule 192, for taxpayers owning, controlling, or possessing tangible business personal property and fixtures with a full cash value of \$300,000 or more, these audits must be completed at least once in each four-year period.

However, an in-depth audit is not always required for each year in the four-year period. The auditor is allowed to "sample" one year in the four year audit period.²¹² If no discrepancy or irregularity is found, there is no requirement to audit the remaining years. If a discrepancy is found, the auditor must continue and audit the remaining years unless (1) the discrepancy or irregularity in the "sample" year is peculiar to that year and (2) the discrepancy or irregularity did not result in an escape.

Nonmandatory Audits

Nonmandatory audits are audits not required by law, but are authorized by section 470 and Rule 192(e). They should be done in addition to mandatory audits, and are selected at the discretion of the assessor because an audit program is not complete unless it includes a representative sample from all sizes and types of property. Performance of nonmandatory audits is part of the representative sample.

²¹² Rule 193.

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The assessor is not prohibited from auditing any taxpayer during any period allowed under the statute of limitations. The assessor may audit a taxpayer every year if it is necessary. However, this would not be prudent or efficient for either the taxpayer or the assessor in most situations.

Depending on the resources available, it may be difficult to complete a large number of nonmandatory audits. Counties may therefore develop criteria for selecting these audits rather than just random selection. Examples of criteria appropriate for selection may include: identified discrepancies; accounts just below the mandatory audit cut-off; inconsistent, incomplete, or non-filed property statements; taxpayer's request for audit; and/or selection by type of business.

Waivered Audits (Waiver of Statute of Limitations)

In most cases, audits must be completed within four years after July 1 of the assessment year the property escaped assessment (i.e., an escape assessment for the year 1997-98 must be enrolled prior to July 1, 2001) because roll changes resulting from audits are subject to the statute of limitations pursuant to section 532.²¹³ If any audit (mandatory or nonmandatory) cannot be completed prior to that time, the taxpayer may agree to waive the statute of limitations (i.e., extend the allowable time period) by signing a waiver.

Section 532.1 allows for the extension of time when the taxpayer and the assessor have agreed in writing to extend the time allowed for making an *escape assessment, correction, and refund*.²¹⁴ Section 532.1, *Extension of time for making escape assessment*, in part reads:

(a) If, before the expiration of the period specified in Section 532 for making an escape assessment, the taxpayer and the assessor have agreed in writing to extend the time for making an assessment, correction, or claim for refund, the assessment may be made at any time prior to the expiration of the period agreed upon. The period may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

Exempt Organization Audits

Exempt organizations are subject to audit as are any other type of business under section 470 and 469. The provisions of section 470 require any person "owning, claiming, possessing, or controlling property subject to local assessment" to make available a copy of business records. An exempt organization is a "person" owning or possessing property which is *subject to assessment*. The provisions of section 469 apply to a *taxpayer* who has *locally assessable fixtures and personal property* and is *engaged in a profession, trade, or business*. It is proper to consider an exempt organization (such as a church or a nonprofit hospital) as a *taxpayer* since the organization would be assessed and taxed on the value of such property, but for the exemption.

²¹³ If conditions exist that warrant a penalty application of 25 percent, as provided in sections 502 and 504 (section 863 for state assessed property) the time limit is extended to 6 years. (Section 532(a) for locally assessed property and section 866 for state assessed property)

²¹⁴ A waiver which does not specifically state that it extends the time for *corrections and refunds* only extends the time allowed for an *escape assessment*.

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Property owned by an exempt organization is assessable, even though there may not be a net taxable value.²¹⁵ However, the type of audit performed for an exempt organization should focus on (1) whether the property is used exclusively for religious, hospital, scientific, or charitable purposes per section 214 and (2) whether the property is owned and operated by the charitable organization. The assessor should only audit critical statements concerning the exemption claim form. The relevant items to audit and the extent (thoroughness) of such an audit should be determined in cooperation with the assessor's exemption department.

Intercounty Cooperative Program Audits (Co-Op Audits)

Many counties conduct audits through the intercounty cooperative audit program. It can be an efficient and effective means of audit for both the assessor and the taxpayer. Using this program, the assessor's staff in the county where the taxpayer is headquartered performs the audit for all participating counties. A similar arrangement is used for taxpayers headquartered out-of-state. One auditor may go to a particular state or city and perform audits for all counties who have audit accounts there. This program saves time and money for all.

Audits By Mail

As indicated earlier, section 470 requires the taxpayer to make records available upon request of the assessor at the taxpayer's principal place of business in California, or at a mutually agreeable location. This may be difficult if the business records and/or the business headquarters is out-of-state or out-of-county. In this case, the assessor may use the intercounty audit program (as discussed above) or the taxpayer may pay the county for the auditor's travel expenses.²¹⁶ Another solution is to conduct the audit by mail, whether mandatory or nonmandatory. Although audit by mail is an option, it may only be feasible for specific types of audits (e.g., accounts audited in the past with minimal changes in the current period). Policy on conducting audits by mail should be determined by each individual assessor and department.

Office Audits

Another alternative for performing either mandatory or nonmandatory audits is to conduct office audits. Using this system, the taxpayer is requested to bring applicable records and information to the assessor rather than the assessor going to the taxpayer's location. The assessor may find this has limited use however. When volumes of information are needed, it is not logical for the taxpayer to physically transport his or her records.

²¹⁵ An exempt organization may pay taxes in certain circumstances and they may have possession of property taxable to another assessee. For example, many exempt organizations pay taxes on non-qualifying property. Some may pay taxes because they filed an exemption claim late, and in other cases they may be contractually required to pay taxes on leased equipment. Commonly, exempt organizations lease equipment from non-exempt lessors. Also, the land and buildings of exempt organizations are subject to special assessment levies even though the property qualifies for exemption from general property taxes.

²¹⁶ Section 470(b).

DRAFT**PREPARATION FOR THE AUDIT****REVIEW OF INFORMATION**

An auditor should review all applicable information available prior to an audit appointment in order to become familiar with the taxpayer, the nature of the business, and the potential problems that may be encountered. This review may include, but is not limited to:

1. Review of property statements as filed (or change of ownership statements if applicable)
2. Review of prior audit (if any)
3. Review of real property land and structure records
4. Review of applicable Revenue and Taxation Code sections
5. Identification of suspected problems needing attention (e.g., trade level adjustments, reporting inconsistencies, etc.)
6. Review of lessor files for lease, cost, and assessment information if the subject company leases equipment
7. Review of assessment roll for associated entities²¹⁷
8. Review of prior owner's property statements, if the business has undergone a change in ownership recently or if a change in ownership affects the current owner's reported cost and/or value

These will give the auditor a preview of the audit ahead and for a smoother audit appointment and overall audit process. In some cases, the auditor will find no obvious problems or areas of concern. In other cases, potential problems will be clearly evident. In such case, the auditor can concentrate on these potential problems and/or discuss them with the taxpayer during the initial phases of the audit. The review will also help determine whether specific records will be needed for pre-identified problem areas.

CONTACT TAXPAYER

An auditor must contact the taxpayer to determine where and when an audit will be conducted pursuant to Rule 191. (It is also helpful to determine with whom the audit will be conducted.) An audit appointment should be scheduled to give the taxpayer (or their agent) sufficient time to prepare for the visit. When an audit covers a four-year time period, or if the taxpayer has never been audited before, a week or two may be needed to gather all the information requested.²¹⁸ Setting an appropriate and convenient date for both parties can help to avoid canceled appointments and/or second visits to a taxpayer's office.

²¹⁷ If there are associated entities, it may be proper to audit all associated accounts.

²¹⁸ At this point, the taxpayer may question the auditor's authority to review their records. Refer to *Statutory Provisions* at the beginning of this chapter for Revenue and Taxation sections granting authority to the assessor.

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It is also critical to inform the taxpayer of what records will be necessary and to verify that the records will be available for audit prior to arriving on site. This allows the taxpayer to schedule accordingly and also aids in avoiding unnecessary delay.²¹⁹ Basic records to be available on site include:

1. Chart of Accounts
2. General Ledger, and Subsidiary Ledgers supporting the general ledger
3. Detailed Fixed Asset List, or Depreciation Schedule
4. Income Tax Returns
5. Invoices and Other Source Documents (purchase orders, receiving records, lease agreements, appropriation records and work orders for construction projects, etc.)
6. Financial Statements and/or Annual Reports
7. Accounting Procedures manuals
8. Independent Audit Reports (if any)
9. Insurance Policy(s)

This list can be expanded based on the preliminary review, and discussions with the taxpayer. If the taxpayer has more than one account or location in the county, or if property owned by others is at the situs of the business, the list and the audit may include records for more than one company and/or assessor's account numbers. If the taxpayer is unique, such as a leasing company, the taxpayer may have "unique" records. These records should be reviewed in addition to the typical records listed above.

CONDUCTING AN AUDIT

Professionalism is important when conducting an audit since the auditor is a representative of the assessor. The pre-audit review, as discussed earlier, helps to organize the auditor and contributes to a professional attitude and image. In addition, some basic audit basic rules should always be observed:

1. Maintain confidentiality of any information obtained
2. Be professional, courteous, and cooperative
3. Decline offers of gratuity

²¹⁹ A follow-up letter can also help by confirming the appointment and by providing a more detailed list of the records which will be required.

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4. Avoid conversations unrelated to the audit; such as: political, religious, or argumentative discussions
5. Avoid drawing premature conclusions
6. Disrupt the taxpayer as little as possible. Wait until you have several items to discuss before approaching them.

At the audit appointment, the auditors should accomplish three main tasks: (1) gather general information regarding the company, (2) review records pertaining to the valuation of property, and (3) take a tour of the facility and equipment being audited.

GATHER GENERAL INFORMATION REGARDING COMPANY

A short initial interview with the taxpayer (or agent) at the beginning of an audit appointment can help to quickly acquaint the auditor with the books and records, and the company's concerns. This generally facilitates the remainder of the audit, and allows the taxpayer to continue business with fewer interruptions.

The pre-audit review and the audit checklist²²⁰ help to determine relevant questions which should be asked at this interview. Such questions may include inquiries pertaining to:

1. Ownership type -- *sole proprietor, partnership, corporation, or other.*
2. Explanation of records provided -- *year-ending, organization of records, etc.*
3. Control -- *verification if there has been a change in control during the audit period (LEOP section 64, compare state tax returns).*
4. Type of accounting system -- *(Accrual Basis v. Cash Basis)*

Accrual Basis

The accrual system of accounting gives recognition to income items during the fiscal period in which they were earned although the cash may not have been received. Expenses are recorded when incurred even though the actual payment has not been made. The accrual system theoretically provides for the timely recording of accounting data by the taxpayer and is generally acceptable for purposes of audit. However, late postings are common. Actual posting practices should be verified.

Cash Basis

The cash basis of accounting gives recognition to income and expense only when actually received or paid. When a cash basis system is encountered, the auditor must restore the accounting data to an accrual basis. For example, the taxpayer

²²⁰ See sample audit checklist in Appendix XX.

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may only be capitalizing cash payments actually made instead of the total purchase price.

5. Capitalization policy: *What is the capitalization policy (including lease buy-outs)? When are capitalized assets recorded? (Important in determining if all assets are booked on lien date.) What is the value minimum for capitalizing assets? How are cost components treated: sales/use tax, installation charges, freight, trade-in allowance, repairs, etc.?*

6. Construction in progress: *How is construction in progress treated in the accounting records? Is it reported? What is included? Are expenditures posted when incurred, when invoiced (frequently contractors do not send a bill until weeks or months after some of the work has been completed), or when paid (even "accrual basis" companies sometimes use "cash basis" for construction in progress). Is overhead recorded? Is construction interest recorded? How are change orders recorded?*

7. Policy of writing off assets: *How are fully-depreciated assets treated? Are they listed on the depreciation schedule and on the books? How are scrapped or sold assets treated? How often are they taken off the books and the depreciation schedule? How often is a physical inventory of fixed assets conducted?*

Note: A taxpayer's policy and procedure for recording disposals aids an auditor in determining how accurately an asset listing represents the assets owned and possessed by the taxpayer. However, it is significant to note that the process of retirement and disposal is generally not as rigid as the purchase. Thus, there may be assets on the books that have been disposed of.

8. Situs: *Where are assets located? Are all the assets located at one location? Are all the assets in the county? Are all the assets in the state?*

9. Recording trade-in allowances: *How are trade-in allowances treated on the books and on the depreciation schedule?*

10. Internal control -- *A company's system of internal control, including EDP (electronic data processing) data entry and retrieval and software controls, is vital evidence in support of the recorded transactions and financial statements. Basic characteristics of sound internal control include: appropriate segregation of responsibilities; reasonable accounting control over assets, liabilities, revenues, and expenses; and sound practices followed by quality personnel in the performance of duties and functions in each department.*

These questions should be expanded upon and altered based on the auditor's review of information prior to the audit, the taxpayer's responses provided during the interview, and as further information is gathered. Answers to these questions will expand or limit the scope of the audit, and allow the auditor to focus more research into identified problems from the start.

DRAFT**REVIEW RECORDS**

The records requested from and provided by the taxpayer are related to the company's financial statements and position as asserted by management.²²¹ Once these records are gathered, the auditor must identify all data pertinent to the audit in order to verify assessable cost.

Verification of Machinery and Equipment**Reconciliation of Sources**

In the verification of machinery and equipment, the auditor is primarily concerned that assessable costs and years of acquisition were properly reported. This information is normally found in two sets of sources (1) general ledger fixed asset accounts or subsidiary ledgers, and (2) on depreciation schedules or fixed asset listings.

When two sources are available, they should be reconciled. This reconciliation can aid in compiling a complete, accurate asset list that can be used as a basis for the audit. An example of reconciliation of sources is listed below:

Example 8.1: Reconciliation of Sources Depreciation Schedule and General Ledger Account	
Total Depreciable Asset Cost Per Depreciation Schedule (FYE 1998)	\$ 125,000
Machinery & Equipment Asset Account #XX1 Per General Ledger (FYE 1998)	(100,000)
Difference Depreciation Schedule - General Ledger	\$ 25,000
Less: Non-assessable Licensed Vehicles (included in General Ledger Account #XX2)	(15,000)
Goodwill (included in General Ledger Account #XX3)	(5,000)
Disposals Unrecorded on Depreciation Schedule	(5,000)
Difference Depreciation Schedule - General Ledger	\$ 0

When both cost totals (cost per depreciation schedule and cost per general ledger fixed asset accounts) are reconcilable, as in Example 8.1 above, the auditor can use the depreciation schedule (which contains specific equipment information) as a basis for the audited cost and make adjustments as necessary. When the cost totals are not reconcilable, the auditor should make an effort to determine why there is a difference before using cost as a basis for cost or before utilizing another method of appraisal (e.g., comparative sales or income approach). For instance, in Example 8.1 three adjustments were made to the cost per books. If any one of those

²²¹ Based on generally accepted accounting principles (GAAP) the financial statements are implied or expressed representations by management. Management makes, in these financial statements, assertions regarding (1) existence and occurrence of assets, obligations, and equities, (2) completeness of the statements, (3) rights and obligations (i.e., assets are the rights of the company and liabilities are the obligation of the company), (4) valuation and allocation (i.e., asset, liability, equity, revenue, and expense have been included in the financial statements at the proper amount under GAAP), and (5) presentation and disclosure (i.e., the financial statements are classified, described, and disclosed properly).

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had not been identified (non-assessable licensed vehicles, goodwill, or unrecorded disposals), a difference would have resulted. An auditor would then need to (or attempt to) determine what adjustment was missed.

Sampling to Confirm Accuracy

An auditor can also use the compiled asset listing to select source documents to sample and compare to the booked cost. This may include such things as purchase invoices, transportation invoices, and receiving reports. This sampling serves two purposes. First, it enables an auditor to verify correctness of acquisition date as recorded on the depreciation schedule. Second, it enables an auditor to verify that assessable cost is equal to the cost reported on the depreciation schedule. The recorded cost may not include all cost components necessary to use the cost approach. The cost components (sales tax, freight, trade-in allowances, etc.) should be verified to include all cost items necessary to put the equipment to use.²²²

Other Adjustments

After reviewing the source documents selected for sampling and determining accurate cost and acquisition date information, an auditor should also determine if any other machinery and equipment or other personal property exists that is not on the depreciation schedule or in the fixed asset accounts. Small, short-lived equipment is an example of equipment which may not be included here (i.e., on the depreciation, in the general ledger asset accounts) since this equipment may not be capitalized. Equipment such as hand tools are commonly expensed rather than capitalized, depending upon the taxpayer's capitalization policy. Expense accounts should be reviewed for these types of items as well as leased equipment. Leased equipment may not be physically identifiable in most cases, but can be located by reviewing accounting records. Payments for these leases may be noted in Notes Payable and/or Expense Accounts, and can be easily missed, if an auditor is not careful to identify them.

Farm audits, in particular, require special attention to items that may have been sold, traded-in, junked, or otherwise abandoned. Farm asset lists tend to be out-of-date more often than other types of business and can be more difficult to reconcile. While the taxpayer should in all situations substantiate any and all changes and deletions not indicated on the books, the auditor should attempt to identify problems and discuss them as soon as possible. This will make for easier post-audit work and audit recommendations.

Classification

The auditor should also verify that assessable property was classified correctly when reported by the taxpayer. For example, were printers reported in the proper column on the property statement and properly classified? Or were they erroneously reported and therefore incorrectly valued? Classification is important, since value relies upon it.²²³

²²² See also Chapter 4: *Valuation of Personal Property*, Valid Cost Components

²²³ Chapter 2, *Classification*, discusses classification in detail.

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Equipment should not necessarily be classified based solely on the classification groups provided on the property statement (equipment; office equipment; tools, molds, and dies, etc.). The asset listing of a business may include several different groups of equipment, and the business may operate distinct units (manufacturing, packaging, warehousing, etc.), whose values fluctuate independently. Thus, it may be necessary for each group of equipment to be classified and valued separately (i.e., using the cost approach, different index factors apply to different groups of assets).

Verification of Improvements

Verification of improvement and building accounts is similar to verification of machinery and equipment. As with machinery and equipment, the auditor must make sure that reported costs, acquisition dates, and classifications are accurate. Improvements are frequently included with machinery and equipment on the depreciation schedule, but will generally be separated in the general ledger accounts.

When it is determined that information gathered regarding improvements is accurate and proper classifications have been made, the auditor should also verify that (1) improvements were not duplicately assessed with the real property assessment, and (2) all improvements were assessed (i.e., no escapes). This usually involves coordination with a real property appraiser, and/or review of the real property appraisal record.

Verification of Supplies

The audit of supplies consists primarily of ensuring that reported supplies on hand have been properly reported by the taxpayer. "Properly reported" meaning that (1) supplies do not include exempt inventory items, and (2) supplies include all assessable supply items.

Where taxpayers maintain a supply inventory account in the general ledger, the auditor must verify that the account is properly maintained and contains all purchases received prior to the lien date. Where supplies are expensed, the auditor must review the supply expense accounts over the prior year. Based on this review, discussions with the taxpayer regarding the amount of supplies on hand, and observation during the plant tour, an auditor should be able to effectively estimate a lien date supply amount.

Verification of Construction In Progress

The verification of construction in progress (CIP) involves matching expenditures to the existence of physical property as well as properly classifying that property. The assessed value is then estimated based on what a sale (transaction) of that property in the market place would bring involving a willing buyer and seller.

Where progress payments are being made, the taxpayer's books may reflect a considerable amount of expenditures in the construction in progress account. However, the taxpayer may not yet have possession of the property, or the property may not have existed on the lien date or, as mentioned earlier, the property may have been received or constructed well before the expenditures were posted. Existence and ownership of the items on the lien date are required

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elements for proper assessment. For example, if construction has not started as of the lien date, no cost is assessable, assuming any material on hand belongs to the contractor and is classified as business inventory. If construction has started, an assessment of CIP is appropriate.²²⁴

Similar to verification of leasehold improvements, verification of construction in progress also involves proper classification. Coordination between the auditor and the real property appraiser is necessary to avoid duplicate assessments and escape assessments.

Verification and Identification of Leased Equipment

Errors in reporting and assessing leased equipment frequently occur as discussed Chapter 6. Thus, an audit should include testing for leased equipment.

By reviewing the various records and accounts maintained by a taxpayer, an auditor can discover, identify, and verify all leases or security arrangements. The principal sources of obtaining information for leased equipment are:

1. General Ledger -- *accounts, (such as lease and rental expense, accounts payable, and notes payable) in the general ledger will indicate whether the taxpayer was making lease or rental payments on the lien date.*
2. Cash Disbursements Journal -- *this record will indicate the amounts and payees of lease and rental payments.*
3. Lease Contracts -- *The monthly lease payment indicated on the lease contract should be compared to the amounts shown in the expense accounts. This will verify that all leases are accounted for and what costs are included in the lease payment/cost.*
4. Financial Statements -- *The financial statements may indicate not only the existence of leases but may also give important information associate with such leases. The footnotes give a summary of the rental and lease commitments regarding operating leases (short-term or cancelable leases which the risks of ownership lie with the lessor, FASB 13). The balance sheet gives information regarding leases similar to that found in the general ledger accounts.*
5. Other Sources -- *Discussions with the taxpayer and/or physical inspection of the premises may indicate the existence of leased equipment.*

When the auditor has identified all leases, a comparison should be made between the lessor and the lessee accounts to confirm accurate reporting (i.e., was the appropriate cost(s) reported at the appropriate trade-level) and correct assessment (i.e., was valued correctly, no duplicate assessment occurred, and no proper assessment was omitted).

²²⁴ Determination of value should be based on market value on the lien date. See Chapter 7, *Special Issues*, for further discussion of construction in progress valuation.

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Certain items tend to cause problems in reporting and valuations. In reviewing a taxpayer's records and reported costs, an auditor may avoid some problems by discovering information sufficient to answer the questions listed below:

1. Does the reported or booked cost include all assessable costs? (*sales/use tax, freight, installation, etc.*)
2. Is all taxable property listed in the accounting records? (*fully-depreciated equipment, leased equipment, property belonging to other entities, expensed personal property, equipment purchased near lien date, interest during construction, etc.*)
3. Are all booked costs taxable? (*goodwill, covenant not to compete, unrecorded disposals, exempt property, rental equipment not on rent on the lien date, inventory, licensed vehicles, commercial coaches, etc.*)

To determine other items that may require special attention in certain circumstances, reference should be made to the three valuation chapters in this section: Chapter 4, *Valuation of Personal Property*; Chapter 5, *Assessments of Improvements Related to Business Property*; and Chapter 6, *Special Issues*.

Special Situations

Equipment located at a taxpayer's place of business, but not owned by the taxpayer needs special attention and consideration. This equipment may not be capitalized. Vending equipment, loaned equipment, and government-owned equipment are good examples.²²⁵ Discussions regarding auditing for this type of property is discussed below since different audit procedures are necessary in discovery and valuation.

Vending Equipment

Vending equipment may or may not involve a written contract between the owner and the possessor. The possessor does not normally incur any expenses regarding the equipment but may derive income from the source. Therefore, miscellaneous income accounts should be analyzed to obtain information regarding this type of income and property.

Loaned Equipment

Discovery of loaned or borrowed equipment is a particularly difficult area in terms of discovery because the possessor of the property, the taxpayer under audit, may or may not derive any income or incur any expense from the property. The following items may aid the auditor in the discovery and assessment of such equipment:

²²⁵ Leased equipment is also equipment located at a taxpayer's business location that may not be owned by them. Verification and identification of leased equipment was discussed earlier in the chapter.

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1. Capitalized installation charges
2. Royalty payments for items produced on loaned equipment
3. Expensed maintenance or repairs on the equipment
4. Memorandum entries
5. Insurance policies
6. Contract or other written agreement(s) between the owner and the possessor

Government-Owned Equipment

Another item to consider when conducting an audit is government-owned property. Property owned by the government and used by a taxable entity may be subject to a possessory interest assessment only, but the property remains an item under audit (see also *Leases With the Government* in Chapter 6). The primary sources for discovering and obtaining information regarding government-owned property and contracts with the government are:

1. Facilities Contracts and/or Supplies and Services Contracts -- *companies holding government-owned equipment will generally have a Facilities Contract and/or a Supplies and Services Contract with the government. These contracts require the firm to maintain accounting and property controls for the equipment and to make periodic status reports to the controlling governmental agency. These records will generally identify each equipment item and the specific location.*
2. Physical Inspection of the Premises -- *most government-owned property is required to be tagged, or otherwise visually identifiable as being government property.*
3. Capitalized Installation or Other Costs -- *the taxpayer may have capitalized installation or other costs in connection with government-owned equipment. An analysis of the structures, leasehold improvement and equipment accounts may alert the auditor of the existence of government-owned equipment.*

When government-owned property is identified, it is imperative that the auditor ascertain which items should be classified as fixtures and which items are personal property. Only fixtures and other real property, owned by the government but possessed by a taxable entity, are subject to assessment (possessory interest).²²⁶ Possessory interests in personal property are not taxable.²²⁷ As discussed in detail in Chapter 2, *Classification*, this classification should be based on:

²²⁶ Taxable *possessory interests* are defined in section 107.

²²⁷ There is one exception. Section 201.5 specifies that possessory interests in pollution control property--whether real property or personal property--acquired by or for the California Pollution Control Financing Authority are taxable.

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1. The manner of annexation
2. The adaptability to the use and purpose for which the realty is used
3. The intention of the party making the annexation as indicated by the physical facts.

Total Property Audits

Total property appraisals refer to appraisals in which the entire property (consisting of land, building, and equipment) is appraised as "one appraisal unit," normally in concert with the real property appraiser. Total property appraisals typically involve the most complex and valuable properties. All three approaches to value may be considered in arriving at the final appraised value.

A total property audit, therefore, involves the verification of considerably more information than a typical audit that focuses primarily on equipment and supplies. It is important to verify all information that is relevant to the appraisal of the entire property. In addition to basic records, the auditor will also need to focus on:

1. Profit and Loss Statements -- *for use in income approach*
2. Tenant Improvements -- *costs included in a total property appraisal*
3. Lease Agreements -- *important in certain operations such as shopping centers and office building rentals. The essential terms of the contract must be extracted (lease term, monthly rent, maintenance provisions, tax provisions, etc.). Where possible, a copy of the entire contract may be helpful.*
4. Construction Contracts -- *furnish a general description of the type of construction and also of any identify special items such as special foundations not readily discernible through a physical inspection. Also, excess costs of construction, if any, might be indicated.*
5. Plant Utilization -- *data concerning whether the facilities are being used for purposes originally intended. Also, whether there is unused capacity.*
6. Market Studies and Forecast -- *supply the expectation of future business for the firm. May indicate how soon any unused capacity might be utilized.*
7. Plot Plan -- *detailed plot plans should be received from all total property taxpayers.*

Audits of Leasing Companies

Audits of leasing companies involve unusual and distinct problems. The auditor must verify that:

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1. All equipment owned by the company located in the county has been reported.
2. The correct location of the equipment has been furnished on the property statement.
3. The correct cost and sales information has been reported by the lessor.
4. The costs reported correspond with the appropriate level of trade at which the equipment is situated on the lien date (i.e., the cost is reported at the proper trade level).

In addition to the books of original entry and property records found in most types of businesses, the following items may be required to gather the necessary information for an audit of a leasing company:

1. Lease Contracts -- furnish complete information on lease costs and lease dates. A primary requirement of leasing company audits is that the auditor obtain copies of (at least) several executed lease contracts for lessees in the County.
2. Audit Referrals -- in addition to the accounting records of the lessor, use of leased equipment referral forms (resulting from processing property statements or conducting audits of lessees), may be helpful. The referrals will contain information from property statements filed by lessee(s) and information extracted during audits of lessees. This information can be compared to the lessor's records to determine whether the lessor has reported all equipment.
3. Control Records -- geographic controls for sales and use tax purposes which can be utilized to verify leases in a particular county. This is particularly critical since in many cases, lessors record their leases at the lessee's headquarters but in fact the lessee may locate the equipment at a different situs.
4. Accounts Receivable Ledger -- furnishes names and other information about customers, which may aid in discovery.
5. Retail Pricing Lists -- furnishes current selling prices of similar equipment, which may aid in verification of estimated value and determination of proper trade level cost.

The auditor is responsible for establishing the total in place replacement or reproduction cost new of leased equipment in order to implement to cost approach to value. For review, the total cost may include (but is not limited to):

1. Purchase price of equipment
2. Sales or use tax
3. Freight
4. Installation and set up costs
5. Machinery foundation costs

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6. Cost of major repairs that extend the useful life of the equipment or materially increase its capacity

7. Trade level adjustments where applicable

Each of these costs should be verified. It may be necessary to also review the lessee's accounting records to gather all applicable information (e.g., situs) and costs, and ultimately determine total assessable cost.

In determining this total assessable cost and reviewing a taxpayer's property statement, an auditor should take care to look for common problems listed below.

COMMON PROBLEM AREAS REGARDING AUDITS OF LEASING COMPANIES:

1. Situs Dates

Some companies consider an item leased only when the item is operational or when the monthly billings commence. Monthly billing may not start until after long extensive testing is completed, especially on complex types of equipment. To determine proper treatment on the lien date, it is important to ascertain the various dates a taxpayer uses (i.e., define the term such as date of installation, rental date, effective date, termination date, shipping date, acceptance date, and date of manufacture).

2. Recognition and Reporting of Proper Trade Level

A leasing company may be reporting booked cost of an asset that does not correspond to the level at which the property is being used on the lien date. For example, when the lessor is also the manufacturer of the leased equipment, the booked (and reported) cost may be the manufactured cost. The actual value of the equipment to the user/lessee on the lien date may be more than that manufacturer's cost (to include profit margin, sales tax, etc.). The auditor should determine what the proper trade level cost is per Rule 10, and whether it is being reported. (See also trade level and leased equipment valuation discussions in Chapter 4 and Chapter 6.)

3. Assignment of Leases and Lease Rights

An assignment occurs when one lessor (the assignor) "transfers" or sells property out on lease to another lessor (the assignee). Assigned leases may not be reported by either party (the assignor or the assignee), and may not be reported by the lessee holding the property. An audit of a leasing company should include a review of records concerning assignments to ensure that all such equipment is reported.

4. Lease Purchase

A leasing company may or may not report Purchase-Option Leases. These are leases which are essentially sales, rather than "true leases" as defined in Chapter 6. When purchase-option leases are not reported by the leasing company, neither the lessor or the

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lessee may be reporting the equipment. A review of the lessor's records may identify such unreported property.

5. Sales-Lease Backs

Many companies advance money to customers using existing equipment as collateral. These "leases" may or may not reflect the true cost of the equipment because many of these arrangements are based on the lessee's ability to pay, and not on the cost of the equipment. Documents concerning sale-lease backs, including the original purchase documents, should be reviewed to estimate the full economic cost. A physical inspection of the property may also be necessary to confirm the appropriate value.

6. Service and Warranty Contracts

Leases may include costs for non-assessable service items. These costs should be deducted where they do not influence the value of the property.

7. Computer Software

Leases may include costs for non-assessable software. These costs should be deducted where appropriate under the exemption of section 995 and Rule 152 as discussed in Chapter 6.

8. Special Leases

Many lessors have separate controls for those items which are special purpose leases or are not currently active. The auditor should make certain that the following categories of leases have been accounted for

- Leases in litigation
- Terminated leases
- Lease purchases
- Government Service Administration (GSA) leases
- Education leases
- Local Government leases
- Software Leases
- Sub-Leases

INSPECTION OF PROPERTY

At some point during an audit, the auditor should take a tour of the premises to physically inspect the property being appraised. This is an important part of the audit process. A tour and inspection of the property being appraised (audited) contributes to the audit in the following

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ways: (1) confirms existence and location of the property, (2) confirms correct classification of the property, (3) verifies the condition of the property, (4) verifies that all property is recorded in the books and/or reported on the property statement, (5) verifies that all property on the books actually exist at the location, and (6) verifies that valuation of the property as a whole is reasonable and accurate.

It is not necessary for the auditor to specifically identify each and every piece of equipment. It is, however, important to compare and reconcile a sample of the assets compiled based on review of the records against actual existing assets viewed during the tour and vice versa. This sample should be large enough to reasonably conclude the accuracy and completeness of the records being used as a basis for the assessable cost.

AUDIT VALUATION AND SUMMARIZED FINDINGS

When all information is gathered and reviewed, an auditor must analyze the data and summarize the results. Within this portion of the audit, an auditor will (1) compare audited cost to reported cost, (2) appraise the property and estimate audited value, (3) compare audited value to assessed value, and finally, (4) produce findings in audit work papers.

COMPARE AUDITED COST TO REPORTED COST

Comparing audited cost to taxpayer's reported cost by year of acquisition and classification type is the first step in the summarization process. This will determine where and how costs were misreported, if at all, and will provide insight into how the overall value may be affected.

For complex audits, a reconciliation of audited cost to taxpayer's reported cost may be appropriate. Following is an example which illustrates how the difference between audited cost and reported cost can be reconciled. The example is for illustration purposes only. In practice, the reconciliation of audited cost to reported cost may include more detailed explanations of the difference, such as acquisition years of property listed under the differences section of the worksheet and audit years affected by the differences. In other circumstances, the cause of a difference may not be identifiable.

DRAFT**Example 8.2: Reconciliation of Reported Cost to Audited Cost**

	<u>Machinery</u>	Office <u>Equip.</u>	<u>Computers</u>	<u>Fixtures</u>	<u>Total</u>
Reported Cost (FYE 1998)	\$ 100,000	\$ 25,000	0	\$ 25,000	\$ 150,000
Audited Cost (FYE 1998)	<u>120,000</u>	<u>20,000</u>	<u>5,000</u>	<u>25,000</u>	<u>170,000</u>
Difference	<u>\$ 20,000</u>	<u>(\$5,000)</u>	<u>\$ 5,000</u>	<u>\$ 0</u>	<u>\$ 20,000</u>
Difference due to:					
Unreported freight & installation	\$ 10,000	\$ 5,000			\$ 15,000
Misclassified equipment		(5,000)	5,000		0
Exempt software		(5,000)			(5,000)
Unrecorded assets acquired and received prior to lien date	10,000				10,000
Total Difference	<u>\$ 20,000</u>	<u>(\$ 5,000)</u>	<u>\$ 5,000</u>	<u>\$ 0</u>	<u>\$ 20,000</u>

AUDITED VALUE

Using audited cost, an audited value for each class of property is estimated and/or a total audited value (of all these classes) is computed. Most often this is done using the cost approach to value; in some cases, the audit may require another method of valuation (i.e., comparative sales or income approach). For a thorough discussion of value see Chapters 4, 5, and 6.

COMPARE AUDITED VALUE TO ASSESSED VALUE

The audited value is compared to the original assessed (enrolled) value. The difference determines the net value change (escape assessment or correction) appropriate for that year.²²⁸

An example of a format used for this comparison is shown below:

²²⁸ Roll procedures for processing escape assessments and corrections are discussed in Chapter 9.

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Example 8.3: Summary of Value			
Year _____			
	ENROLLED VALUE	AUDITED VALUE	DIFFERENCE
Supplies			
Construction-In-Progress (CIP)			
Machinery & Equipment			
Office Equipment			
Other Equipment			
Tools, Molds, & Dies			
Computers & Related			
Real Property (except fixtures)			
Fixtures			
TOTAL			Net Value Change

1

2 FINAL PRODUCT: AUDIT WORK PAPERS

3 Every audit, regardless of its complexity or its size, should contain certain basic information in
 4 the form of working papers which flow logically. These working papers include schedules of
 5 analysis and supporting documents which are a summary of the events of the audit and a summary
 6 of the audit findings. Without organization, the audit cannot be used by the auditor, by a
 7 reviewer, by the taxpayer, or by others to ensure that the audit results are reasonable and for
 8 purposes of appraising the property in the future.

9 Minimum contents of an audit should include (1) a summary of findings, (2) a written narrative
 10 summarizing the events and audit process, and (3) other working papers. The format and/or
 11 order of these documents should be determined by each individual county, but should be
 12 consistent for each audit within that county.

13 Summary of Findings

14 A summary of findings should be included in the first few pages of an audit. This is where the
 15 audited cost and value are compared with the original cost and value, and the net differences
 16 (escapes, correction, or refunds) are noted for each year audited. An audit checklist should also
 17 be included here. The checklist is vital for an audit to be thorough, efficient, and complete. It
 18 contains questions pertinent to the taxpayer as well as reminders relating to the various segments
 19 of the audit. In the case of an audit that is limited in scope, the checklist clarifies that only
 20 specific items were examined. These reminders may be checked off as covered. A sample
 21 checklist is included in the Appendix XX of this manual.

22 Audit Narrative

23 The audit narrative is a key feature of an audit in that it allows the audit to be quickly reviewed or
 24 used by others (users may include the audit supervisor, the taxpayer, another auditor or appraiser,

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the appeals board, etc.) in the future. It details and explains the summary of findings (including the areas of discrepancy and their causes), the auditor's conclusions as a result of the findings, and the recommendations made for or against penalties. The narrative must describe in sufficient detail the work performed, and the auditing standards and procedures used to support the conclusion(s). All of these facts must be presented in a concise manner without eliminating significant substantive matter, and should logically follow the sequence of the working papers. It is particularly important to report clearly any unusual adjustment to cost or valuation procedures to guide the taxpayer and appraisers for making future reporting and assessments.

Other Working Papers

Other working papers included in an audit package will consist of all documents necessary to support the information on the summary sheets and in the narrative to make the audit complete. These papers will differ from county to county and even between audits. But in all cases, they serve to:

- Provide support for the audit report
- Aid in the planning, performance, and review of audits
- Document whether the audit objectives were achieved
- Provide support in the event that a taxpayer disputes or appeals
- Demonstrate compliance with property tax laws and state guidelines
- Provide clear directions on adjustments made to costs, for trade level, for obsolescence, and other items so that problems encountered in the audit are less likely to be repeated by the taxpayer and/or assessor's staff.

Audit working papers should be complete and include support for all audit conclusions reached. Among other things, audit working papers may include:

- Audit report and taxpayer responses
- Control questionnaires, flowcharts, checklists, and narratives
- Value calculations, assumptions, and conclusions
- Analysis and tests of transactions, processes, and account balances (i.e., spreadsheets developed by the auditor)
- Copies of depreciation schedules (or asset lists), invoices, etc.
- Sampling method utilized
- Audit correspondence if it documents audit conclusions reached
- Information about operating and financial policies
- Planning documents and audit programs
- Notes resulting from interviews

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Regardless of the type of papers included in this section, the audit should be logically organized and, if lengthy, clearly indexed. A reader should be able to follow the progression and use the audit to determine how the final conclusion was reached.

REVIEW BY SUPERVISOR

After the field work is completed and the audit write-up is finalized, the audit is submitted to an appropriate reviewer for verification of technical and legal correctness. The audit report, audit findings, and all working papers is reviewed to ensure that the proper audit procedures have been performed, and that the findings are supported by evidence and substantiating documents. Upon completion of review, the supervisor will return the audit for further explanations or corrections deemed necessary. At this point, the audit is essentially complete. The next step is to notify the taxpayer of findings, and process roll corrections.

NOTIFY TAXPAYER OF FINDINGS

Pursuant to Rule 191, section 408(e)(1), and section 469 the assessor is required to notify the taxpayer, in writing, of audit results. These findings should include an explanation of differences found, problems identified, and the net result. Where an escape assessment applies, a *Notice of Proposed Escape Assessment* must also be sent at least 10 days prior to entry on the roll as required by section 531.8.²²⁹

Rule 191 states, in pertinent part, as follows:

After having considered the results of the audit, including discussions with and written comments of the taxpayer, the assessor shall inform the taxpayer of his conclusions as to the value of the property and may (1) cause an escape assessment to be made, (2) make an assessment subject to penalty, or (3) inform the taxpayer of his right to a cancellation or assessment or refund of taxes.²³⁰

Although not required under the rule or statutes, it may be advisable for the auditor to explain results and findings to the taxpayer and/or their agent in some situations.

The taxpayer then has the option to agree, dispute, or request amendment to the audit. When the taxpayer agrees to the audit findings, roll corrections are processed as necessary. When the taxpayer disputes the findings, the taxpayer and the assessor should try to (and in some cases can) resolve areas of disagreement in order for roll corrections to be processed. In the case where disagreements cannot be resolved, and the audit results in an escape, the taxpayer does have the right to appeal the audit results.²³¹

²²⁹ See Chapter 9 for more discussion of section 531.8.

²³⁰ Rule 191.

²³¹ Sections 469 and 1605 provide that an audit resulting in an escape assessment subjects all the property of the taxpayer at that location to review, equalization, and adjustment for the year of such escape (unless the property was previously equalized for the year). The taxpayer has 60 days after the date of notification to file on appeal.

DRAFT**ROLL PROCEDURES FOR PROCESSING ROLL CHANGES**

Roll changes are the final step in the audit process. As discussed earlier in the chapter, escape assessments or corrections must normally be completed within four years after July 1 of the assessment year the property escaped assessment or otherwise pursuant to section 532. Where they are not entered on the roll as required by this section, the assessment is not permitted.²³² They must also be processed at the tax rate applicable to the year they should have been originally assessed. Chapter 9 discusses this topic.

The legislative intent of these provisions was to afford the taxpayer a similar right to 'open up' past assessments as the assessor has.

²³² *City of Los Angeles v. County of Inyo* (1959) 167 Cal.App.2d 736.

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CHAPTER 9: ROLL PROCEDURES

IDENTIFYING ROLL ERRORS

For a wide variety of reasons, the initial assessment roll inevitably contains errors. Common errors include errors in value judgment, "clerical" (calculation) errors, errors caused by the failure of property owners to report correctly (or to report at all), and various misunderstandings. Typical examples specific to the business division include:

- a property statement disclosing information erroneously omitted in previous year(s) (either by the taxpayer when reported or by the assessor when processing);
- an audit resulting in a net change (increase or decrease) in assessed value;
- a taxpayer failing to inform the assessor that a business was closed;
- an assessor discovering a business owning taxable property after the initial year of operation and assessability.

Such errors result in overassessments, underassessments, misclassifications, assessments to the wrong assesseees, assessments assigned to the wrong tax-rate jurisdictions, and other problems that result in incorrect assessments.

In general, California law provides, within specified time limitations, that an erroneous assessment is to be corrected, regardless of the cause of the error and regardless of whether the error resulted in an overassessment or an underassessment. If the value of property that should be on the roll is determined to be different than the enrolled value (an audit resulting in a net increase, for example), the enrolled value must be corrected according to statutory provisions. Both the limitation on time (statute of limitations) and the procedure for making a correction vary greatly according to the nature and the cause of the error. The procedures set forth in the statutes must be followed.

ESCAPE ASSESSMENTS

An *escape assessment* is an assessment made after the completion of the regular assessment roll that is after the assessor has certified the completion of the local roll prepared pursuant to section 601.²³³ It is any addition to that roll regardless of the reason.

Section 531 requires the assessor to make an escape assessment if (1) the taxpayer does not file a property statement and the result is no assessment, or (2) upon discovery of any

²³³ Escape assessments for state assessed properties may either be added to the fiscal year in which it is discovered or included with the assessments for the succeeding fiscal year (section 864).

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other underassessment of property.²³⁴ When an escape is based on failure to file a property statement (including circumstances where the statement is incomplete when filed and returned to the taxpayer), the assessor is also required to add penalties and interest to the assessment. Section 531 states:

If any property belonging on the local roll has escaped assessment, the assessor shall assess the property on discovery at its value on the lien date for the year for which it escaped assessment. It shall be subject to the tax rate in effect in the year of its escape except as provided in Section 2905 of this code.

Property shall be deemed to have escaped assessment when its owner fails to file a property statement pursuant to the provisions of Section 441, to the extent that this failure results in no assessment or an assessment at a valuation lower than would have obtained had the property been properly reported.

Escape assessments made as the result of an owner's failure to file a property statement as herein provided shall be subject to the penalty and interest imposed by Sections 463 and 506, respectively. This provision shall not constitute a limitation on any other provision of this article.

Escape assessments are also required when it is discovered that an exemption was granted in error,²³⁵ and when the business inventory exemption was incorrectly applied.²³⁶ The statutes also provide for escape assessments when taxpayers do not provide accurate information requested by the assessor necessary to compute a valid assessment. When accurate information is available to the assessor that indicates a higher assessment is required than that originally enrolled, the additional value is enrolled as an escape assessment. Sections 531.3 and 531.4 both provide for escape of the property incorrectly reported. Section 531.3 provides, in part:

If the assessor requires an assessee to describe personal property in such detail as shows the cost thereof but the assessee omits to report the cost of the property accurately, notwithstanding that this information is available to the assessee, to the extent that this omission on the part of the assessee causes the assessor not to assess the property or to assess it at a lower valuation than he would enter upon the roll were the cost reported to him accurately, that portion of the property as to which the cost is unreported, in whole or in part, shall be assessed as required by law....

²³⁴ Roll changes may not be necessary for property having a low value if the total taxes, special assessments and applicable subventions on the property would amount to less than the cost of assessing and collecting them (section 155.20). The low value and this section must be authorized by the county board of supervisors.

²³⁵ Section 531.1.

²³⁶ Section 531.5.

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Section 531.4 specifically discusses escape assessments in terms of inaccurate property statements. In part, it reads:

When an assessee files with the assessor a *property statement* or report on a form prescribed by the board with respect to property held or used in a profession, trade or business and the statement fails to report any taxable tangible property accurately, regardless of whether this information is available to the assessee, to the extent that this failure causes the assessor not to assess the property or to assess it at a lower valuation than he would enter on the roll if the property had been reported to him accurately, that portion of the property which is not reported accurately, in whole or in part, shall be assessed as required by law. (Italics Added.)

In addition, both sections 531.3 and 531.4 discuss the application of penalties and interest as provided in sections 504 and 506. When it is discovered that an additional assessment is

required for a previous roll year, it is important to determine the reason for the missed assessment. For example, the missed assessment may be due to either an assessor or taxpayer error. If it is a taxpayer error, the failure to report costs accurately may be due to an unintentional mistake or willful misreporting. Provisions in the code allow for penalties and interest depending in part on the reason for the escape assessment.

TAX RATE AND INTEREST

Section 506 indicates the appropriate tax rate and interest to be applied to escape assessments. The language provides that the tax rate applicable to any escape assessment shall be:

...the tax rate to which the property would have been subject if it appeared upon the roll in the year when it should have been lawfully assessed. To the tax there shall be added interest at the rate of three-fourths of 1 percent per month from the date or dates the taxes would have become delinquent if they had been timely assessed to the date the additional assessment is added to the assessment roll.

Basically, the *tax rate* is the rate of the year of escape, and the *delinquency date* is the date the taxes would have become delinquent if the property was reported timely. The date the escape assessment is entered on the roll (the *date of enrollment*) is important in terms of the interest computation. The *date of enrollment* of the escape is the date the interest computation stops (interest computation starting with delinquency date if property reported and assessed timely). The *interest rate* is applied for the number of months from delinquency date to roll entry date (three-fourths of 1 percent per month).

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PENALTY

Penalties are applied to escape assessments under certain conditions. If the property statement is not filed or was not filed timely in accordance with sections 441 and 463, a 10 percent penalty must be applied to the assessed value. The application of the penalty may only be abated by the county board of equalization or assessment appeals board. Therefore, if a taxpayer does not agree with the penalty, an application for changed assessment (appeal) must be filed.

A 25 percent penalty may be applied to the assessed value if the assessor discovers that the taxpayer or agent willfully concealed information that resulted in a lower assessed value.²³⁷ Section 503 provides for the application of a 75 percent penalty to the assessed value if it is discovered that the property is underassessed due to a fraudulent act or omission, or fraudulent collusion between the taxpayer (or the taxpayer's agent) and the assessor (or the assessor's deputy). The interest and the penalties (if appropriate) of the additional assessed value are added to escape assessments calculated on that additional assessed value.

STATUTE OF LIMITATIONS

In most cases, escape assessments must be made within four years after July 1 of the assessment year the property escaped assessment. This time period is extended to six years if conditions exist that warrant the 25 percent penalty application in sections 502 and 504.²³⁸

The statutory time period for making an escape assessment is also extended if the taxpayer and the assessor agree in writing to extend the time. Section 532.1, *Extension of time for making escape assessment*, in part reads:

- (a) If, before the expiration of the period specified in Section 532 for making an escape assessment, the taxpayer and the assessor have agreed in writing to extend the time for making an assessment, correction, or claim for refund, the assessment may be made at any time prior to the expiration of the period agreed upon. The period may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

This agreement in writing may also be known as a waiver. Each county develops its own form, therefore the titles of the forms, in addition to the actual agreements, may be different.²³⁹ In all cases, however, the waiver should indicate that it extends the time allowed for making an *escape assessment, correction, and refund*. If the waiver does not

²³⁷ Sections 502 and 504.

²³⁸ Section 532.

²³⁹ The form with the agreement that extends the time limitation for processing an escape is not a Board prescribed form. The format and title of the form may differ between counties.

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specifically state that it extends the time for corrections and refunds, then it only extends the time for making an escape assessment.

NOTICE OF PROPOSED ESCAPE ASSESSMENT

It is required that the taxpayer be notified using a *Notice of Proposed Escape Assessment* at least 10 days prior to the entry of a value on the roll, pursuant to section 531.8. In relevant part, section 531.8 reads:

No escape assessment shall be levied under this article before 10 days after the assessor has mailed or otherwise delivered to the affected taxpayer a "Notice of Proposed Escape Assessment" with respect to one or more specified tax years.

The intent was to provide taxpayers' with advance notice of an escape assessment before its enrollment, thereby increasing their opportunity to ask questions and prepare to file an appeal. The notice may differ in appearance and content from county to county (as it is not required on a Board-prescribed form), but certain information must be included in order to meet the statutory requirements. For example, every *Notice of Proposed Escape Assessment* must show the amount of any escape assessment as estimated by the assessor; provide a name and phone number of a person at the assessor's office to whom the taxpayer can voice any concerns, submit additional information, or otherwise discuss the assessment; and have a prominent heading stating the statutory title of the Notice. This notice must be sent by the assessor prior to enrolling any escape. When an audit results in escape assessments, the *Notice of Proposed Escape Assessment* may be attached to audit findings or may be sent independently along with other sources of information.

ENTRY ON ROLL

When an escape assessment is made, the entry on the roll must reference the year the property escaped assessment and applicable sections of the Revenue and Taxation Code. Section 533 gives specific wording that must be entered on the roll. In part, the section states:

...if this is not the roll for the assessment year in which the property escaped assessment, the entry shall be followed with "Escaped assessment for year 19__ pursuant to Sections _____ of the Revenue and Taxation Code."

Since appropriate section of the Revenue and Taxation Code must be referenced when the entry on the roll is made, it is important to determine if the missed assessment was due to a taxpayer error or an assessor error and/or concealment or fraud, or to an assessor error. The cause of the escape determines the appropriate section references.

In addition, the escape assessment is not property made or "enrolled", unless the taxpayer is (1) notified by a Notice of Proposed Escape Assessment at least 10 days prior to the

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entry of the value on the roll, as discussed above, and (2) notified within 60 days after the statute of limitations or the placing of the escape assessment on the roll. Otherwise, the escape assessment is deemed made only on the date the assessee is so notified, or upon the date of receipt of the tax bill (section 534).

ROLL CORRECTIONS

Roll corrections must be made within four years after making the original assessment which is being corrected. A change to the original entry on the assessment roll is a *roll correction* when:

- a clerical error is caused by the assessor or another county official, whether the error resulted in an increase or a decrease to the original entry on the roll (section 4831).
- a clerical error is caused by an assessee, based on a defect of description or other information discovered upon an audit, and it resulted in an assessment at a higher valuation than would have otherwise been entered on the roll (section 4831.5).²⁴⁰

Roll corrections are different from escape assessments in several respects.

1. No penalties are involved with roll corrections.
2. While escape assessments may result from a roll correction, a roll correction cannot be made for escape assessments when caused by the assessee's failure to report the information required under section 441.
3. Roll corrections are limited to clerical errors only, and cannot be made for errors or omissions involving the exercise of value judgment except in limited circumstances per section 4831(b).
4. The roll correction could result in a refund to the taxpayer, and if based on an assessor error, the taxpayer is entitled to interest.²⁴¹

REFUNDS

If a roll correction decreases the amount of taxes due to an error by either the assessee or the assessor, a refund of the overpayment of taxes is possible. Refunds of taxes paid are authorized solely under the conditions described in sections 5096 through 5180. While a thorough discussion of these sections (sections 5096-5180) is not within the realm of this manual, it is important to note that it is the assessor's duty is to deliver the corrected entry to the

²⁴⁰ Assessee error that results with an addition to the roll is an escape assessment, see sections 501 to 534.

²⁴¹ Section 5151.

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auditor, who is required by section 4834 to implement correction procedures. The tax collector is required to notify the taxpayer of the right to file a refund claim.

It may be appropriate for **taxes** to be offset by the auditor and the tax collector pursuant to section 533. In part, the section reads:

If the assessments are made as a result of an audit which discloses that property assessed to the party audited has been incorrectly assessed either for a past tax year for which taxes have been paid and a claim for refund is not _____ barred _____ by Section 5097 or for any tax year for which the taxes are unpaid, the proposed tax liabilities, including accumulated penalties and interest, resulting from escaped assessments for any tax year covered by the audit.

BASE YEAR VALUE CORRECTIONS

Although applicable only to real property (including fixtures) valued under Proposition 13, it is important to make the distinction between *roll corrections* and *base year value corrections*. Roll corrections and base year value corrections are not identical.

Section 51.5 provides authority for assessors to make corrections to base year value whenever it is discovered that a base year value does not reflect applicable constitutional or statutory valuation standards or the base year value was omitted. If an error or omission involves the exercise of the assessor's judgment as to value, the error can be corrected only if it is placed on the current roll or roll being prepared within four years after July 1 of the assessment year for which the base year value was established. Escape assessments, refunds or the cancellations of taxes are authorized where appropriate as the result of a base year value correction.

**SUMMARY OF REVENUE AND TAXATION CODE SECTIONS REGARDING
ROLL PROCEDURES**

The following table represents a summary of the Revenue and Taxation Code sections referenced regarding roll procedures (escape assessments, corrections, refunds, and base year value corrections). This table is supplied as a reference tool only. It does not quote the sections listed, but rather provides a brief synopsis of each section for quick reference to the authoritative law on each subject.

DRAFT**Table 9A: Revenue and Taxation Code Sections Applicable to Roll Procedures**

R & T Reference	Remarks
Section 463	<u>Penalty for failure to file statement.</u> A penalty, 10 percent of assessed value, is applied when a property statement is not filed in accordance with filing requirements and deadlines as identified in sections 441 and 463, respectively. The penalty may be applied to the regular roll, or applied to additions made to the roll after originally completed and published. It may only be abated by the county board of equalization or assessment appeals board.
Section 502	<u>Concealment, etc., of tangible personal property.</u> A penalty, 25 percent of the additional assessed value as provided in section 504, is applied if the taxpayer or agent willfully conceals information that results with a lower assessed value. The penalty is applied to additions made to the roll after originally completed and published.
Section 503	<u>Fraudulent act, collusion, causing escape of taxable tangible property.</u> A penalty, 75 percent of the additional assessed value, is applied if through a fraudulent act or omission, or fraudulent collusion, the property is underassessed in whole or in part. The penalty is applied to additions made to the roll after originally completed and published.
Section 504	<u>Penalty assessments; amounts.</u> Indicates percentage of penalty added if required per section 502 (25 percent).
Section 506	<u>Tax rate applicable, interest.</u> The tax rate is the rate of the year of escape. Apply interest for the number of months from delinquency date to roll entry date. Interest is applied at the rate of three-fourths of 1 percent per month from the date the taxes would have become delinquent if filed timely.
Section 531	<u>Escaped Property.</u> Property is deemed to have escaped assessment under this section when its owner fails to file a property statement per section 441 resulting in no assessment or an underassessment. No willful or fraudulent act is involved.
Section 531.1	<u>Escaped property, incorrect exemption.</u> If it is discovered that an exemption was incorrectly allowed, an escape assessment shall be made.
Section 531.3	<u>Escaped personal property, failure to report cost accurately.</u> Escape assessment due to inaccurate report of personal property cost when assessor required a cost report.
Section 531.4	<u>Escaped business property, inaccurate statement or report.</u> Escape assessment due to inaccurate business property statement or report.
Section 531.5	<u>Escaped property, business inventory exemption.</u> Escape assessment due to the application of an incorrect business inventory exemption.

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Table 9A: Revenue and Taxation Code Sections Applicable to Roll Procedures	
R & T Reference	Remarks
Section 531.8	<u>Notice of Proposed Escape Assessment.</u> Requires 10 day notice to taxpayer prior to enrollment of escape assessment.
Section 532	<u>Statute of limitations.</u> Six year statute of limitations where 25 percent (sections 502 and 504) nondisclosure or fraud penalty applies. Four year statute of limitations where no penalty involved.
Section 532.1	<u>Extension of time for making escape assessment.</u> Extends the time period specified in section 532 for making an escape assessment, correction, or claim for refund. (Extension only applies to corrections and refunds if specifically stated in the written agreement between the taxpayer and assessor.)
Section 533	<u>Entry on roll.</u> For assessments made pursuant to article 3 or 4 (commencing with sections 501 and 531 respectively), the entry on the roll is to state: "Escaped assessment for year 19__ pursuant to Sections _____ of the Revenue and Taxation Code."
Section 534	<u>Procedure after assessment.</u> Tax rate to be applied: same rate as used for year of escape. (See also section 506.)
Section 4831	<u>Incorrect entries; transfers to unsecured roll.</u> Any assessor error. Result of an incorrect entry on the roll or clerical error.
Section 4831.5	<u>Correction of errors caused by the assessee.</u> Correction to the roll when information furnished to the assessor resulted with an overassessment of the property.
Sections 5096-5180	<u>Refunds.</u> Various code sections related to refunds.
Section 51.5	<u>Errors and omissions in determination of base year value.</u> Provides authority to correct base year values.
Sections 830, 862 - 866, 4876 - 4880	<u>Failure to File Statement, Escape Assessments of State-Assessed Property; Errors on the Board Roll.</u> Code sections governing roll changes for state-assessed property.

DRAFT**MORGAN PROPERTY TAXPAYERS' BILL OF RIGHTS****LEGISLATIVE INTENT**

The *Morgan Property Taxpayers' Bill of Rights*, sections 5900 through 5911, was designed and added to the Code to promote fair administration of property tax in regard to the rights and duties of taxpayers, and specifically in reference to taxpayer questions, appeals, and roll changes when errors have occurred.²⁴² The Legislature specifically stated their intent in section 5911 by stating:

It is the intent of the Legislature in enacting this part to ensure that:

(a) Taxpayers are provided fair and understandable explanations of their rights and duties with respect to property taxation, prompt resolution of legitimate questions and appeals regarding their property taxes, and prompt corrections when errors have occurred in property tax assessments.

(b) The board designate a taxpayer's advocate position independent of, but not duplicative of, the board's existing property tax programs, to be specifically responsible for reviewing property tax matters from the viewpoint of the taxpayer, and to review and report on, and to recommend to the board's executive officer any necessary changes with respect to, property tax matters as described in this part.

As described in subdivision (b) above, the Property Taxpayers' Advocate is responsible for implementing the *Taxpayers' Bill of Rights*. The advocate is appointed by the Board and serves to review the effectiveness of the Board's property tax programs, including those affecting local assessment, from the taxpayers' viewpoint, by (1) providing clearly-written informational

materials to property taxpayers; (2) prompt and adequate resolution of inquiries, complaints, and other problems; and (3) identification of areas of recurring conflict between taxpayers and property tax assessment officials.

Related specifically to personal property (and fixtures) and roll procedures, the *Taxpayers' Bill of Rights* initiated legislation in three other important sections of the code: section 531.8, *Notice of Proposed Escape Assessment*, requiring additional taxpayer notice of escape assessments; section 469, *Audit of profession, trade, or business*; and section 408, *Assessor's records*, dealing with records available to the assessee.

NOTICE OF PROPOSED ESCAPE ASSESSMENT

As discussed earlier, section 531.8 was added January 1, 1994 with the *Taxpayers' Bill of Rights* to aid in the taxpayers' understanding of their rights and duties with respect to

²⁴² Effective January 1, 1994.

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property taxation, and to promote fairness. This notice must be sent by the assessor prior to enrolling any escape assessment.

RECORDS AVAILABLE TO THE ASSESSEE

The right of taxpayers and the public to inspect public records of all types are prescribed by law, the majority of which is found in the Public Records Act (Government Code Sections 6250-6260). In Government Code section 6254(I), the Public Records Act prohibits from public disclosure any taxpayer information which is received in confidence and the disclosure of which would result in unfair competitive disadvantage to the taxpayer.

However, the Legislature has adopted specific Revenue and Taxation Code provisions (section 408-4083.3) granting both the public at large and assessee's rights to inspect specific types of information in the assessors' records. As to the public rights, the assessment roll and its index, owners' maps and assessors' maps, property characteristics information, claims for exemption (except homeowner's) and other forms must be disclosed. For the assessee or his/her representative, all information related to the appraisal and assessment of his/her own property, including audit and roll change information, must be disclosed. Under section 408(d),

...the assessor shall, upon request of an assessee of property, or his or her designated representative, permit the assessee or representative to inspect or copy all information, documents, and records, including auditors' narrations and workpapers...relating to the appraisal and assessment of the assessee's property, and any penalties and interest....²⁴³

As part of the amendments to the *Taxpayers' Bill of Rights*, section 408 was expanded, increasing the taxpayers' rights to inspect or copy various types of documents including "auditors' narrations and workpapers, whether or not required to be kept or prepared by the assessor." (section 408(e))

Pursuant to further amendments under the Taxpayers' Bill of Rights, section 469 was also modified to guarantee the taxpayer a copy of the assessor's findings upon the completion of an audit. The assessor is *required* to give the audit findings (all audit narratives and workpapers relating to the audit, appraisal, and assessment of the property) in writing to the taxpayer. The *assessor must provide* information under section 469, whether or not the taxpayer requests the information as required under section 408.

Right to Appeal

The taxpayer has two means of protesting a property tax assessment. The first is to contact the assessor (i.e., the appraiser or the auditor appraiser) prior to enrollment of the

²⁴³ Section 408(e).

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assessment and explain why they believe the value is incorrect. Once enrolled, the taxpayer's option is to file an application for assessment appeal. A taxpayer may request this application and information regarding the appeals process from either the assessor or the clerk of the county board of supervisors.

An appeal may be filed on an assessment only within the applicable filing periods, according to statutory provisions related to the particular assessment in question.²⁴⁴ Whether the property be real or personal property, applications for assessments on the *regular assessment roll*²⁴⁵ must be filed with the county assessment appeals board between *July 2 and September 15*. Assessments made outside the regular assessment period (usually based on escape assessment due to audit or late filings of property statements) must be appealed according to statutory provisions found in sections 469 and 1605. Pursuant to these sections, an appeal must be filed within 60 days of receipt of the notice of assessment.²⁴⁶ The 60 days does not begin on the receipt of the *Notice of Proposed Escape Assessment* (per section 531.8), but on receipt of notice of escape assessment as defined in section 534.

When an application for assessment appeal is filed timely regarding an escape assessment resulting from an audit, *all* property owned by a taxpayer at the location is opened up for appeal. This includes the real property on which the personal property is located, even if the original appeal deadline was missed (unless previously equalized). The following provision in section 469 states:

If an audit of the books and records of any profession, trade, or business pursuant to Section 469 discloses property *subject to an escaped assessment* for any year, then the original assessment of all property of the assessee at the location of the profession, trade, or business for that year shall be subject to review, equalization and adjustment by the county board of equalization or assessment appeals board....²⁴⁷ (Italics added.)

The legislative intent of this provision is to afford the taxpayer a similar right to "open up" past assessments as the assessor has.²⁴⁸

For more information regarding assessment appeals and the statutory provisions governing the appeals process and procedures, refer to the *Assessment Appeals Procedures Manual* published by the Board of Equalization.

²⁴⁴ An appeal cannot be filed at the county level on a claim for exemption. A county assessment appeals board does not have authority to grant or deny an exemption (Rule 302).

²⁴⁵ The *regular assessment roll* is that roll processed during the period from January 1 to and including July 1 of the calendar year in which the assessment should have been enrolled if had been timely made (section 1605(f)).

²⁴⁶ Section 1603(b). See section 619 for more information on notice of assessment.

²⁴⁷ Section 1605(e), in part.

²⁴⁸ Section 469.